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Supreme Court, U.S.
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No.

In the Supreme Court of the United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

GEORGE PRUSSIN AND SHARON PRUSSIN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTION PRESENTED

Whether a taxpayer who acquires income-producing property, subject to a contemporaneous nonrecourse indebtedness that greatly exceeds the fair market value of the property, is entitled to take deductions for accrued interest and depreciation computed on the basis of a portion of the nonrecourse indebtedness that corresponds to the fair market value of the collateral.

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The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-33a) is reported at 863 F.2d 263. The opinion of the court of appeals denying the Commissioner's petition for rehearing (App., *infra*, 34a-37a) is reported at 863 F.2d 277. The opinion of the Tax Court (App., *infra*, 38a-61a) is reported at 54 T.C.M. (CCH) 566.

JURISDICTION

The judgment of the court of appeals (App., *infra*, 62a-63a) was entered on November 25, 1988. A petition for rehearing was denied on January 30, 1989. App.,

infra, 34a-37a. On April 20, 1989, Justice Brennan extended the time within which to petition for a writ of certiorari to and including June 29, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The Internal Revenue Code of 1954 (26 U.S.C. (1976)), as in effect for the years 1978 and 1979, provided in pertinent part:

§ 163. Interest

(a) General rule.

There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

§ 167. Depreciation

(a) General rule.

There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * *

(g) Basis for depreciation.

The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section

1011 for the purpose of determining the gain on the sale or other disposition of such property.

§ 1011. Adjusted basis for determining gain or loss

(a) General rule.

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

§ 1012. Basis of property – cost

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapter C (relating to corporate distributions and adjustments), K (relating to partnerships and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

STATEMENT

1. This is an income tax case involving the tax liability of an investor who purchased an interest in a limited partnership that had been formed to acquire and operate a garden apartment complex. Respondent George Prussin[1]

[1] Respondent Sharon Prussin joined in the petition to the Tax Court and in the appeal to the Third Circuit in this case solely because she filed a joint return with her husband George Prussin for each of

purchased limited partnership units in Pleasant Summit Associates (PSA). App., *infra,* 6a. PSA is a limited partnership that purchased the buildings comprising the Summit House in West Orange, New Jersey, from Pleasant Summit Land Corporation (PSLC) in June 1978, for a stated consideration of $7,759,200. *Id.* at 4a-5a, 41a. That transaction was, as the Tax Court explicitly found, "motivated by little more than a desire for tax benefits." *Id.* at 56a.

In June 1978, PSLC actually entered into three transactions involving the Summit House. First, PSLC completed the purchase of the Summit House from a group of individuals for $4,200,000 (of which $250,000 was paid in cash). Second, PSLC sold the buildings and personal property, but not the underlying land, to a wholly owned subsidiary for $5,200,000 (of which $500,000 was to be paid in cash, and $4,700,000 was a nonrecourse wraparound mortgage). Third, PSLC then sold all of the stock of the subsidiary to the partnership (PSA) for a nonrecourse note for $2,559,200, secured by the stock of the subsidiary. The partnership immediately dissolved the subsidiary corporation and took direct ownership of the Summit House buildings, subject to the prior wraparound mortgage (and, of course, to the nonrecourse note given for the stock). It is not clear from the record whether the partnership also paid the dissolved corporation's $500,000 cash obligation to PSLC. The partnership took from PSLC a 90-year lease on the underlying land, calling for annual rental payments of $10,000. App., *infra,* 4a-5a, 40a-41a.

On its partnership tax returns for the taxable years 1978 and 1979, PSA reported losses in the amount of $1,805,246 and $1,494,243, respectively. App., *infra,* 47a. In each of

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the taxable years in suit. Accordingly, for convenience, we will sometimes refer to George Prussin as "respondent."

those years, the partnership claimed deductions in excess of $2,100,000, most of which were attributable to accelerated depreciation deductions on the Summit House property and to accrued but unpaid interest on the nonrecourse financing. *Ibid.*; C.A. App. 340a, 371a. On their joint federal income tax returns for 1978 and 1979, respondents took deductions of $417,012 and $345,170, respectively, as their distributive shares of the partnership losses. App., *infra,* 8a.[2]

On examination of the books and records of PSA, the Commissioner of Internal Revenue issued a notice of deficiency disallowing respondent's deductions for his share of the claimed partnership losses in their entirety. App., *infra,* 8a, 48a; C.A. App. 270a. The theory of the disallowance was that the Summit House was subject to nonrecourse obligations that unreasonably exceeded the fair market value of the property, and that as a result PSA had no real investment in the property and was not entitled to claim an allowance for depreciation measured by the principal amount of the nonrecourse notes, or to deduct accrued but unpaid interest on the notes. See *Odend'hal* v. *Commissioner,* 748 F.2d 908, 912 (4th Cir. 1984), cert. denied, 471 U.S. 1143 (1985); *Estate of Franklin* v. *Commissioner,* 544 F.2d 1045, 1048-1049 (9th Cir. 1976). See generally *Crane* v. *Commissioner,* 331 U.S. 1, 9-10 (1947).

2. Respondent petitioned the Tax Court for a redetermination of the deficiency asserted by the Commissioner.

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[2] Section 702 of the Internal Revenue Code of 1954 provides that, in calculating the tax liabilities of persons doing business in partnership form, each partner should take into account his distributive share of the income or loss of the partnership. See *United States* v. *Basye,* 410 U.S. 441 (1973). Thus, as the court of appeals recognized in this case, respondent's ability to deduct a distributive share of partnership losses depends on whether the partnership actually suffered cognizable losses. App., *infra,* 19a-20a.

Melvin Isaacson, another limited partner in PSA, also filed a petition to the Tax Court. The Tax Court consolidated the cases of those two petitioners, as well as a petition filed by PSLC challenging the treatment of the gain realized on its sale of the Summit House. The Tax Court sustained the Commissioner's determination that PSA was not entitled to deductions for depreciation and interest computed on the ostensible purchase price, including the nonrecourse notes, because the face amount of the notes unreasonably exceeded the fair market value of the property. App., *infra,* 52a-60a.

The court found that the transaction in which PSA purchased the Summit House from PSLC was not a bona fide sale between parties with adverse economic interests, but was motivated by little more than a desire to generate tax benefits for the investors in PSA. Although that transaction ostensibly involved a consideration of $7,759,200, that consideration consisted mostly of nonrecourse notes, and the transaction took place immediately after PSLC had purchased both the land and buildings in an arm's-length transaction for $4,200,000. The court noted that the amount of fire insurance carried on the buildings ($2,745,000) was consistent with a value of $4,200,000 for the land and buildings, but not with a value of $7,759,200 for the buildings alone. The court observed that PSA had no incentive to obtain the Summit House buildings for the lowest possible price, because its promoters were offering to sell its limited partnership units to investors as a vehicle for obtaining the largest possible tax deductions, rather than as a means of participating in a potentially profitable real estate transaction. Accordingly, the promoters sought to maximize the tax benefits to investors by having the partnership agree to "pay" an inflated price for the property in the form of nonrecourse notes. App., *infra,* 55a-58a.

The Tax Court found that the fair market value of the entire Summit House property could not have been more than $4,200,000 at the time of its acquisition by PSA. It therefore concluded that the purported consideration of $7,759,200 for the buildings alone, of which PSA agreed to pay $7,259,200 in the form of nonrecourse notes, unreasonably exceeded the value of the property. App., *infra,* 58a. Applying the rule set forth in *Estate of Franklin* v. *Commissioner,* 544 F.2d at 1048-1049, the court held that respondent was not entitled to any interest or depreciation deductions attributable to the nonrecourse notes, because the partnership had no economic incentive to pay off the notes in order to preserve the property from foreclosure, and hence respondent had no investment in the property to depreciate and no genuine indebtedness on which to base a deduction for accrued but unpaid interest. App., *infra,* 58a.

3. Both respondent and the estate of Melvin Isaacson (who had died during the pendency of the Tax Court proceeding) appealed from the decision of the Tax Court. Venue for the appeal in *Estate of Isaacson* lay to the Second Circuit because the taxpayers in that case resided in Connecticut when they filed their petition to the Tax Court. Venue for the appeal in this case lay to the Third Circuit because respondent resided in New Jersey when he filed his petition to the Tax Court. See I.R.C. 7482(b)(1)(A).[3] The Second Circuit affirmed the decision of the Tax Court in the companion case. *Estate of Isaacson* v. *Commissioner,* 860 F.2d 55 (1988). In this case, however, the Third Circuit reversed in part. App., *infra,* 1a-33a, 62a-63a.

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[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect during 1978 and 1979, the years at issue (the Code or I.R.C.).

The Third Circuit sustained the Tax Court's factual finding that the amount of nonrecourse indebtedness to which the buildings acquired by PSA were subject unreasonably exceeded the fair market value of the Summit House. App., *infra,* 20a-23a. The court held, however, that that finding did not justify disallowing all interest and depreciation deductions attributable to the nonrecourse debt. Rather, the court concluded that the partnership should be allowed interest deductions attributable to the part of the nonrecourse indebtedness that did not exceed the fair market value of the collateral, and depreciation deductions computed by including that same portion of the nonrecourse debt in its basis for the property. *Id.* at 31a.

The court recognized that the partners may have had no economic incentive to pay off any portion of the nonrecourse debt in order to preserve the property from foreclosure—a fact that would suggest that there was no genuine indebtedness in any amount, and therefore no justification for any deduction. The court reasoned, however, that the holders of the nonrecourse notes would have had no economic incentive to reject an offer by the partnership to pay the fair market value of the property in return for cancellation of the notes. Thus, although it acknowledged that its holding in this regard was in conflict with the Second Circuit's decision in *Estate of Isaacson,* the court of appeals concluded that it was appropriate to treat the nonrecourse indebtedness as genuine indebtedness up to the fair market value of the collateral. App., *infra,* 3a n.2, 31a.

Accordingly, the court of appeals remanded the case to the Tax Court for a determination of the fair market value of the Summit House at the time of its purchase, and for a finding as to the actual cash investment, if any, made by PSA in connection with the purchase of the property. App., *infra,* 33a. The court of appeals sustained the Tax

Court's finding that the fair market value of the property did not exceed $4,200,000. The court therefore directed that on remand respondent should be limited to proving that the property had a fair market value no greater than $4,200,000. *Id.* at 31a & n.18.

4. The Commissioner filed a petition for rehearing in which he argued that the panel's holding allowing a partial deduction for the nonrecourse indebtedness was in conflict not only with the decision of the Second Circuit in *Estate of Isaacson* v. *Commissioner, supra,* but also with those of the Fourth Circuit in *Odend'hal* v. *Commissioner, supra,* and the Ninth Circuit in *Estate of Franklin* v. *Commissioner, supra.* In all of those cases, interest and depreciation deductions were disallowed in their entirety when the nonrecourse indebtedness substantially exceeded a reasonable estimate of the fair market value of the collateral.

The Commissioner also pointed out that the reasoning of the Third Circuit in this case might allow a taxpayer to adjust its basis each year by the amount of the unrealized appreciation in the value of the collateral up to the limit of the nonrecourse debt. That court's logic could have led to that result because, in a rising market, the borrower on a nonrecourse note would have an economic incentive to offer a larger amount each year in order to induce the holders of the nonrecourse debt to enter into the hypothetical compromise on which the court based its analysis. The Commissioner argued that changing the depreciable basis of property each year to reflect such changes in the value on which the taxpayer could base its depreciation and interest deductions would produce unmanageable administrative problems for both taxpayers and the government in calculating the deductions allowable each year and in making the corresponding basis adjustments attributable to the depreciation claimed on property purchased with nonrecourse financing.

The court of appeals denied the Commissioner's petition for rehearing in a published opinion that clarified its earlier opinion. App., *infra,* 34a-37a. The court stated that, under its holding, a purchaser would be entitled to treat as genuine indebtedness only the amount of the nonrecourse debt that did not exceed the fair market value of the collateral on the date of purchase. Such a purchaser would not be permitted to adjust its basis in the property to reflect subsequent changes in its value. *Id.* at 36a-37a. The court distinguished *Odend'hal* and *Estate of Franklin* on the ground that it did not appear from the opinions in those cases that the taxpayers had asserted a right to a partial deduction based on the fair market value of the collateral, whereas respondent in the present case had made such a claim. *Id.* at 35a-36a.

REASONS FOR GRANTING THE PETITION

The court of appeals has decided an important question of federal tax law incorrectly. Its decision conflicts with the decision of the Second Circuit in *Estate of Isaacson* v. *Commissioner, supra,* which affirmed in its entirety the very same Tax Court ruling that the court of appeals here partially reversed. The decision below also conflicts with the previously uniform decisions of other circuits holding that, under *Crane* v. *Commissioner,* 331 U.S. 1, 9-10 (1947), nonrecourse indebtedness may be treated as genuine indebtedness if, but only if, the fair market value of the property securing the debt is at least equal, at the time of acquisition, to the principal amount of the debt. See *Odend'hal* v. *Commissioner,* 748 F.2d 908, 912 (4th Cir. 1984), cert. denied, 471 U.S. 1143 (1985); *Estate of Franklin* v. *Commissioner,* 544 F.2d 1045, 1048-1049 (9th

Cir. 1976); see also *Brannen* v. *Commissioner*, 722 F.2d 695 (11th Cir. 1984).[4]

1. Section 167(a) of the Code provides that "[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear * * * of property used in the [taxpayer's] trade or business, or * * * held for the production of income." Section 167(g) of the Code provides that the taxpayer's basis for calculating depreciation shall be the same as the adjusted basis of the property for purposes of determining the gain on a sale or other disposition of the property, as defined in Section 1011 of the Code. That section, in turn, requires the taxpayer to use the cost of the property as his basis, subject to certain exceptions and adjustments that are not involved in this case. The "cost" of property is defined in Treas. Reg. § 1.1012-1(a) as "the amount paid for such property in cash or other property." Both the consistent administrative practice of the Internal Revenue Service and the decisions of the courts, including this Court, have allowed a taxpayer to include in his cost basis the principal amount of a mortgage if the taxpayer is personally liable for the mortgage or if it encumbers the property and does not ex-

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[4] This is not a case in which the purchaser simply made a bad bargain and gave notes for too much for the property securing the loan. The purchaser should be entitled to treat a nonrecourse loan as genuine indebtedness and to include the amount of the nonrecourse debt in the basis of the property, as long as the purchase price falls within an acceptable range of business judgment. See *Estate of Franklin*, 544 F.2d at 1049. In this case, however, as both courts below agreed, the amount to which the Summit House property was subjected clearly falls outside any reasonable range of business judgment. PSLC bought the land and buildings comprising the Summit House for $4,200,000 in an arm's-length transaction and immediately resold the buildings, without the land, to PSA for an ostensible consideration of $7,759,200, almost all of which consisted of nonrecourse obligations. App., *infra*, 4a-5a, 53a-54a.

ceed a reasonable estimate of the fair market value of the collateral. *Crane* v. *Commissioner,* 331 U.S. at 9-10; *Odend'hal* v. *Commissioner,* 748 F.2d at 912; *Estate of Franklin* v. *Commissioner,* 544 F.2d at 1049; Rev. Rul. 55-675, 1955-2 C.B. 567; see also *Commissioner* v. *Tufts,* 461 U.S. 300 (1983); Rev. Rul. 81-278, 1981-2 C.B. 159; Rev. Rul. 77-110, 1977-1 C.B. 58.

The deductibility of respondent's share of the amount accrued by PSA as interest on the nonrecourse notes collateralized by the Summit House is controlled by Section 163 of the Internal Revenue Code, which allows as a deduction "all interest paid or accrued within the taxable year on indebtedness." In order for any amount to be deductible there must be a valid and enforceable obligation requiring the payment of both principal and interest. *Knetsch* v. *United States,* 364 U.S. 361, 365-366 (1960); *Autenreith* v. *Commissioner,* 115 F.2d 856 (3d Cir. 1940). Here, there is no recourse against the partnership for failure to make payments on the debt; the partnership merely holds property that is encumbered by the obligation. In that situation, the established rule for the deductibility of interest has been that such a nonrecourse obligation gives rise to a genuine indebtedness if, but only if, the value of the property is at least equal to the amount of the debt. As the Ninth Circuit explained in *Estate of Franklin* v. *Commissioner,* 544 F.2d at 1049:

> To justify the deduction the debt must exist; potential existence will not do. For debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to make a capital investment in the amount of the unpaid purchase price.

In the absence of proof that the value of the collateral reasonably approximates the principal amount of the nonrecourse debt, the nonrecourse borrower has no economic incentive to pay off the nonrecourse obligation in order to preserve the property from foreclosure. He has no equity in the property (because his indebtedness exceeds the value of the property), and he has nothing to fear from nonpayment of the debt except loss of the property. He therefore may not include any part of the nonrecourse financing in his basis, nor may he deduct any part of the interest on the supposed debt.

These basic principles had, until this case, produced a uniform line of decisions requiring that an artificially inflated nonrecourse loan be entirely disregarded in computing depreciation and interest deductions. See, *e.g.*, *Estate of Isaacson* v. *Commissioner*, 860 F.2d at 56; *Estate of Franklin* v. *Commissioner*, 544 F.2d at 1048; *Narver* v. *Commissioner*, 75 T.C. 53, 98 (1980); Rev. Rul. 77-110, *supra*.[5] By allowing a partial deduction for both

[5] Although the question presented in this case superficially resembles the question that this Court decided in *Commissioner* v. *Tufts*, *supra*, *Tufts* is not contrary to the decisions cited in the text, and the court below properly did not rely on *Tufts* as support for its decision. In *Tufts*, the Court held that a borrower on a nonrecourse mortgage who sold the property after its fair market value had declined below the face amount of the loan was required to include the full amount of the nonrecourse obligation in the amount realized on the sale. In that case it was undisputed that the nonrecourse loan had all the indicia of genuine indebtedness at the time it was made, and that the Commissioner had treated it as a true loan for purposes of depreciation and interest deductions. See *Odend'hal* v. *Commissioner*, 748 F.2d at 912-913. By contrast, the amount of the nonrecourse loan here was egregiously inflated from the outset, and the borrower therefore never had any economic incentive to repay the loan. See *Estate of Franklin* v. *Commissioner*, 544 F.2d at 1049. The analysis of this Court in *Tufts*, 461 U.S. at 312, was explicitly premised on the fact

depreciation and accrued but unpaid interest attributable to nonrecourse financing, even though the principal amount of the debt unreasonably exceeded the fair market value of the collateral, the court of appeals has overturned the established rule disallowing such deductions in their entirety.

The decision below squarely conflicts with the decision of the Second Circuit in *Estate of Isaacson,* an appeal from the same Tax Court ruling involving another partner in the same tax shelter as the present case. In *Estate of Isaacson,* 860 F.2d at 56, the Second Circuit recited with approval the holding of the Tax Court (App., *infra,* 52a) that, because the nonrecourse mortgages encumbering the Summit House substantially exceeded the fair market value of the property, "no 'investment in the property' occurred and no 'genuine indebtedness' exists." Although the

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that the borrower had "received the loan proceeds tax-free and [had] included them in his basis on the unstanding that he had an obligation to repay the full amount." The Court held that, in those circumstances, "a taxpayer must account for the proceeds of obligations he has received tax-free and included in basis." *Id.* at 313. By contrast, in *Odend'hal,* 748 F.2d at 912, the Fourth Circuit held that the principal amount of a nonrecourse loan could not be included in the taxpayer's basis because the nonrecourse obligation unreasonably exceeded the fair market value of the property, and the taxpayer therefore had no "economic incentive to pay off the debt." Similarly, in *Estate of Franklin,* 544 F.2d at 1048-1049, the Ninth Circuit held that a taxpayer that had ostensibly purchased property subject to a nonrecourse loan had no real investment in the property, and therefore could not claim depreciation and interest deductions computed on the amount of the nonrecourse loan, because the amount of the loan so unreasonably exceeded the fair market value of the collateral that the purported purchaser could "lose no more than a mere chance to acquire an equity in the future" if he abandoned the transaction. Thus, the debt in *Estate of Franklin* and *Odend'hal,* like the debt here, was essentially spurious from the outset; the debt in *Tufts* was essentially genuine, although the value of the encumbered property later declined.

appellant there advanced the same arguments that respondent made in this case,[6] the Second Circuit affirmed the decision of the Tax Court for the reasons set forth in the Tax Court opinion. The Tax Court opinion, as adopted by the Second Circuit, rejects the alternative claim made by the limited partners in both cases that, even if they were not entitled to deduct interest and depreciation computed upon the entire principal amount of the nonrecourse financing, they should be permitted to show that the nonrecourse notes had a value equal to the fair market value of the collateral, and should be allowed to claim interest and depreciation deductions attributable to the nonrecourse debt as thus limited. As the Tax Court noted, no case had ever adopted such a test. *Id.* at 58a-59a. The Third Circuit has now adopted the position rejected by the Tax Court and by the Second Circuit in *Estate of Isaacson*.

The decision here also cannot be reconciled with either the results or the analysis of the decisions in *Odend'hal* and *Estate of Franklin*. In each of those cases, the nonrecourse notes that substantially exceeded the fair market value of the property in question were disregarded in their entirety. In *Estate of Franklin*, 544 F.2d at 1048, the Ninth Circuit observed that, if a purchaser buys property subject to a nonrecourse obligation that is approximately equal to the fair market value of the property, his payments on the nonrecourse note "would rather quickly yield an equity in the property which the purchaser could not prudently abandon." This, the court held, was "the stuff of sub-

[6] Indeed, the appellants in both cases were represented by the same counsel. The appellants and the government each made virtually simultaneous filings in the Second Circuit and in the Third Circuit, and the briefs filed in the two courts were in all pertinent respects identical. Only the outcome was different.

stance" that would cause the form of the transaction to mesh with the realities of the marketplace. The court further pointed out that "[n]o such meshing occurs when the purchase price exceeds a demonstrably reasonable estimate of the fair market value." *Ibid.* In that circumstance, the purchaser would obtain no equity in the property by making payments on the nonrecourse note. The most he could lose by abandoning the transaction would be a mere chance to acquire an equity if the value of the property increased beyond the principal amount of the nonrecourse obligation. The Ninth Circuit held that such a mere chance was insufficient to justify treating the transaction as a sale and allowing the nonrecourse "purchaser" to claim the depreciation and interest deductions that would have been allowable if he had actually held an ownership interest in the property. *Ibid.*

Similarly, in *Odend'hal* v. *Commissioner,* 748 F.2d at 912, the Fourth Circuit held that a taxpayer who had purchased property subject to a nonrecourse debt could include the amount of the loan in his basis

> so long as the fair market value of the property is at least equal to the amount of the nonrecourse debt at the time it was incurred, because the taxpayer, even though he has no personal liability at stake, has an economic incentive to pay off the debt rather than to lose the collateral. But if the stated price financed by nonrecourse debt exceeds the fair market value of the property, to the extent of the excess, the taxpayer has no equity in the property to protect and no economic incentive to pay off the debt.

In the absence of an economic incentive to pay off the nonrecourse loan, *Odend'hal* rejected the taxpayers' claim that the nonrecourse debt should be treated as a true loan, and disallowed all deductions for depreciation and interest

in excess of an amount sufficient to offset the taxpayers' income from the property. *Id.* at 909, 912-913.

2. In the present case, the court of appeals cited with approval the holdings of the Fourth Circuit and the Ninth Circuit that a taxpayer could not deduct depreciation and interest attributable to a nonrecourse note that unreasonably exceeded the fair market value of the property because he had no economic incentive to pay off the debt. App., *infra,* 25a-31a. Nevertheless, the court held that, even though a nonrecourse borrower would have no incentive to pay off the full amount of the debt in order to save the property from foreclosure if the property were worth less than the debt, he did have an economic incentive to offer to compromise the nonrecourse loan by paying the fair market value of the property. If he were to do so, the court added, the holder of the nonrecourse note would have no reason to refuse the offer and force a foreclosure sale. Thus, the court concluded that in this case the partnership had incurred a genuine indebtedness to the extent of the fair market value of the Summit House, so that respondent was entitled to claim depreciation and interest deductions computed on the nonrecourse indebtedness to the extent that it did not exceed the fair market value of the property.

That reasoning is flawed. In the first place, it assumes that the investors in PSA, which was formed as a tax shelter partnership, would have had an incentive to purchase the Summit House property even if the tax benefits had been limited to the fair market value of the property. In the second place, the nonrecourse borrower would not even begin to build up any "equity" in the property so long as the unpaid indebtedness continued to exceed the fair market value of the property. Having no equity in the property to protect, the nonrecourse borrower would have no particular incentive to pay its full fair market value,

even if foreclosure were otherwise imminent. Likewise, the lender would have no particular incentive to accept an offer from the borrower to pay the fair market value of the property in exchange for a discharge of the indebtedness encumbering it. The lender would not, by selling the property to the borrower, recover the full (inflated) amount of the nonrecourse loan but would have to compromise that putative debt for whatever he could receive from the borrower for the property. In those circumstances, a rational lender would just as soon foreclose and offer the property to the highest bidder, who might or might not turn out to be the original nonrecourse borrower. At best, both parties would be in a state of equipoise, even if they were in full agreement as to the present value of the property. At that point, they would simply deal with the property in the same manner as they might deal with any similar property that might then be on the market, without regard to their prior course of dealings with respect to such property.

The hypothetical transaction on which the court of appeals based its decision is thus entirely speculative to begin with. It becomes even more unlikely when one considers the effect of the clarification that the court of appeals issued in denying rehearing. The court explicitly rejected the idea that the amount of the compromise (and therefore the amount of the genuine indebtedness to be taken into account by the purchaser) would be subject to annual revision as the value of the collateral changed. App., *infra*, 36a-37a. The court's rule limiting any deductions to those based on the market value of the property at the time of purchase, although easier to administer than a rule requiring annual valuations, would also virtually guarantee that the compromise contemplated in the court's analysis could never occur.

An example should make the point clear. If the Summit House property were found to have been worth $4,000,000 in June 1978, under the court's analysis that would be the amount of genuine indebtedness that respondent could use in calculating the amount of interest and depreciation that he could claim each year. If the value of the property were to rise to $5,000,000 by June 1979, and the lenders then sought to foreclose, PSA certainly could not expect to be able to prevent the foreclosure by offering $4,000,000, the value of the property one year earlier. In such a situation, the lenders would have an economic incentive to reject the compromise and to force the foreclosure sale in order to capture the appreciation in the value of the property. By contrast, if the value of the property were to decline to $3,000,000, no rational borrower would offer to pay $4,000,000 for it in order to avoid foreclosure. Thus, only in the extremely unlikely circumstance that the property remained at exactly the same value from the date of sale until the date when the lenders decided to foreclose would a compromise, if one were to be made, occur at the price that represented the fair market value of the property on the date of the original sale to the nonrecourse borrower.

The nonrecourse borrower in the circumstances of this case, therefore, has no genuine indebtedness to the lender. It has no more economic incentive than anyone else to make payments of principal and interest to the lender, or to pay the present or past fair market value of the property to the lender in order to compromise the unpaid indebtedness. Hence, it is wrong to allow the borrower to take tax deductions on the basis of an indebtedness that is, for all practical purposes, nonexistent.

3. The decision below, in addition to being erroneous, would, if permitted to stand, produce grave inequities in tax administration and cause a substantial disruption in the efforts of the Internal Revenue Service to achieve a

prompt and fair disposition of a large number of tax shelter cases, especially cases involving real estate shelters. We have been informed by the Internal Revenue Service that there are now approximately 20 national tax shelter projects involving almost 2300 docketed Tax Court cases and more than $630,000,000 in deficiencies that could be adversely affected by the holding of the Third Circuit in this case. In addition, there are large numbers of tax shelter cases not involved in a national litigation project that could be similarly affected.

The potential for disparities in tax treatment arising from the holding of the Third Circuit is well illustrated by the facts of the present case. Because of a difference in appellate venue, respondent and the estate of Melvin Isaacson have been ordered to receive different tax treatment, even though respondent and Isaacson were both limited partners in the same partnership, were the subject of a common adjudication in the Tax Court, and were represented by the same counsel and made the same arguments before their respective courts of appeals. Because tax shelter partnerships are often marketed to investors living in different judicial circuits, the existence of a different rule for the calculation of the depreciation and interest deductions allowable to investors residing within the territorial jurisdiction of the Third Circuit from that which applies elsewhere in the country would produce unseemly confusion and inconsistency. It is therefore appropriate for this Court to grant certiorari to correct the error of the court below and to establish a uniform rule to govern the recurrent fact pattern of this case.

The decision below is of great importance to the public fisc and creates a substantial potential for tax shelter abuse. Under the holdings of the Second, Fourth, and Ninth Circuits in *Estate of Isaacson*, *Odend'hal*, and *Estate of Franklin*, an investor who has purchased prop-

erty subject to a nonrecourse mortgage that unreasonably exceeded the fair market value of the collateral stands to lose all deductions for depreciation and interest attributable to the nonrecourse financing. Under the decision below, by contrast, an investor whose tax shelter deductions have been disallowed will have a substantial incentive to attempt to establish the highest possible value for the collateral on the date of purchase, by litigation if necessary, in order to salvage at least part of the benefits that he claimed on his returns. Thus, in addition to its inherent unsoundness of predicating the allowance of deductions for interest and depreciation on a hypothetical borrower-lender compromise that almost certainly will never occur, the decision below would open the way to frequent valuation litigation and to a form of tax abuse that the decisions of the Second, Fourth, and Ninth Circuits have effectively precluded. Accordingly, review by this Court is necessary to resolve the conflict in the circuits and to restore evenhanded administration of this important aspect of the tax laws.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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JUNE 1989

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 88-1373 and 88-1377

PLEASANT SUMMIT LAND CORPORATION,
APPELLANT IN 88-1373

v.

COMMISSIONER OF INTERNAL REVENUE

GEORGE PRUSSIN AND SHARON PRUSSIN,
APPELLANTS IN 88-1377

v.

COMMISSIONER OF INTERNAL REVENUE

On Appeal from the United States Tax Court
(Tax Court Nos. 30159-82 & 28283-85)

Argued October 7, 1988

BEFORE: HIGGINBOTHAM, MANSMANN, AND GREENBERG,
Circuit Judges

(Filed November 25, 1988)

OPINION OF THE COURT

GREENBERG, Circuit Judge.

Appellants, Pleasant Summit Land Corporation (PSLC) and George and Sharon Prussin, appeal from adverse decisions entered by the Tax Court following a consolidated trial on their petitions to redetermine deficiencies determined by the Commissioner of Internal Revenue. PSLC challenges the Tax Court's conclusion that it was a "personal holding company" subject to the tax on personal holding companies in its tax year in issue. Resolution of its appeal depends on whether its sale of the Summit House apartments in West Orange, New Jersey, was of a capital asset and thus resulted in a capital gain, as it claims, or whether the Summit House was a property it held primarily for sale to customers in the ordinary course of its trade or business so that its sale resulted in ordinary gross income.

George Prussin is an investor in a limited partnership, Pleasant & Summit Associates (PSA), which indirectly purchased Summit House from PSLC. The Prussins challenge the Tax Court's conclusions that: (1) nonrecourse financing of the Summit House purchase exceeded its fair market value; (2) the nonrecourse financing would not support depreciation and interest deductions which they claimed by reason of George Prussin's limited partnership interest in PSA; and (3) these deductions would be disallowed in full rather than only to the extent that they were the product of financing in excess of the fair market value of Summit House. Furthermore, they argue that the complete disallowance of the deductions unconstitutionally violated their right to due process of law.

This court has jurisdiction under section 7482(a) of the Internal Revenue Code of 1954.[1] The Tax Court had jurisdiction under I.R.C. §§ 6213(a), 6214(a), and 7442. Inasmuch as PSLC was a New Jersey corporation with its principal place of business in New Jersey when it filed its petition and filed its appeal to this court and the Prussins were a married couple residing in New Jersey at all times relevant to their petition and appeal, the venue for these appeals property lies in this court.[2]

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[1] The years with respect to which tax liability is contested predate the enactment of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. Thus, while that Act redesignated the Internal Revenue Code of 1954 as the Internal Revenue Code of 1986, *see id.* § 2, we refer throughout this opinion to the 1954 Code which governs the substantive issues.

[2] A related case, *Estate of Isaacson v. Commissioner,* 2d Cir., Docket No. 88-4062, arising from the same transaction but involving different taxpayers, was appealed to the United States Court of Appeals for the Second Circuit. In this related case, the estate of Melvin W. Isaacson and Miriam A. Isaacson appealed from a decision disallowing deductions for depreciation and interest based on Melvin Isaacson's ownership of two limited partnership units in PSA. Venue for the Isaacson appeal lay to the Court of Appeals for the Second Circuit rather than to this court because the Isaacsons resided in Connecticut at the time their tax court petitions were filed. I.R.C. § 7482(b). PSLC and the Prussins in their brief recite that the Commissioner "would not consent to a consolidation of these appeals." On October 24, 1988 the court affirmed the Isaacson appeal in a per curiam opinion for the following reason: "We agree with the reasoning and conclusions of the Tax Court, and, for the reasons set forth in Judge Cohen's thorough opinion, the judgment of the Tax Court is affirmed." Notwithstanding the opinion of the Court of Appeals for the Second Circuit, we have independently arrived at our result which is partially different. We note that in its brief recitation of the facts, the Court of Appeals for the Second Circuit indicated that $500,000 was paid in cash by PSLC for the original purchase. We are confident that the correct figure was $250,000, as set forth by Judge Cohen.

We will affirm the Tax Court's decision with respect to PSLC. We will reverse the Tax Court's decision to the extent it completely disallowed the Prussins' deductions and will remand for a determination of the fair market value of Summit House and for calculation of the appropriate deductions allowable to the Prussins. Since we hold that the Prussins' deductions may be disallowed only in part, their constitutional claim is moot and we do not address it.

I. BACKGROUND

A. *The Underlying Business Transaction*

On May 3, 1978, in an arm's length transaction, PSLC entered into an agreement to purchase the Summit House, a property on Summit Street, West Orange, New Jersey, containing two apartment buildings and a small separate resident manager's apartment for $4,200,000. The purchase was closed on or about June 1, 1978 and the consideration was paid by $250,000 in cash, by delivery of a $1,350,000 note secured by a purchase money mortgage, and by PSLC taking title subject to a previously existing $2,600,000 nonrecourse mortgage.

Contemporaneously with the purchase, PSLC created a wholly owned subsidiary, Mount Orange Realty Corp. (MORC), to which it then sold the Summit House buildings while retaining the land beneath them. The sale price to MORC was $5,200,000, consisting of $500,000 in cash which MORC borrowed or owed and a $4,700,000 nonrecourse mortgage which wrapped around and was subject to the prior two mortgages.[3] The note which this mortgage

[3] The $500,000 was not paid by MORC. A pretrial stipulation indicated that it was to be paid but does not indicate that this happened. In their brief, appellants suggest it was borrowed and was thus owed. It should be noted that the consideration in the PSLC and MORC purchases was divided between personal property and real estate but the allocation is not significant for our purposes.

secured permitted accumulation of interest and principal through December 31, 1988, except that annual interest payments were required up to the available cash flow. This conveyance of the property placed the depreciable buildings in one entity while leaving the nondepreciable land in another.

PSLC then sold its MORC stock to the newly created PSA, which was organized to acquire the Summit House, for $2,559,200, paid in the form of a nonrecourse note secured by the MORC shares, for which a mortgage of Summit House to PSLC was immediately substituted. This note had provisions for accumulation of interest and principal through December 31, 1988, similar to those in the $4,700,000 note. PSA then dissolved MORC, took direct ownership of the Summit House buildings and took over MORC's obligations including the $500,000 due on the purchase of the Summit House and the $4,700,000 nonrecourse wraparound mortgage. Thus, the cost to PSA for acquisition of Summit House was the $2,559,200 indebtedness for the purchase of the MORC shares, assumption of MORC's $500,000 obligation, and assumption of MORC's $4,700,000 nonrecourse wraparound mortgage for a total of $7,759,200. The record, however, does not clearly establish that PSA paid the $500,000. Of course, this assumption of obligations did not transform the nonrecourse debts to recourse obligations. The consequence of these transactions was to leave PSA with large debts with interest charges and a substantial depreciable asset, a situation setting up the possibility for it to claim large tax deductions. Additionally, PSLC leased the land under the buildings to PSA for $10,000 a year under an agreement allowing rent to be accumulated and deferred at a fixed rate of interest. This provision caused PSA to generate additional tax deductions for the interest which accrued on the unpaid rent.

PSA sold thirty limited partnership units to a group of investors including George Prussin for a total of $1,980,000 paid with down payments and subsequent installments. The offering memorandum to the investors indicated that the $500,000 due on the sale from PSLC would be paid from the investors' down payments, leading the Commissioner in his brief to indicate that it appears that MORC's $500,000 obligation for its down payment was satisfied from the investors' funds. Inexplicably, the agreement for sale of the MORC shares between PSLC and PSA included a warranty by PSLC that MORC had no liabilities. Some months after PSA acquired Summit House, a new nonrecourse mortgage was substituted for the prior $2,600,000 mortgage but this did not enhance PSA's risk in the transaction. Most of the foregoing transactions were nearly contemporaneous and thus they formed part of one large structured undertaking.

PSA reported losses on its income tax returns for 1978 and 1979, and later years, largely attributable to interest deductions and depreciation. These losses were passed through to the limited partners who used them to off-set income on their individual tax returns. On December 19, 1985 an unrelated third party purchased the Summit House land from PSLC and the buildings and lease from PSA for a total of $7,000,000.

B. ***The Assessment of Deficiencies Against PSLC***

On its corporate income tax return for its taxable year ending May 31, 1979, PSLC indicated that: (1) it had realized a gain of $3,742,704 on the sale of certain improvements to land in West Orange, New Jersey (Summit House); (2) it elected to use the cost recovery method for reporting this profit; and (3) under this method none of the gain was includable in its gross income for the taxable year covered by the return.

On October 7, 1982, the Commissioner issued a deficiency notice to PSLC. This notice stated that: (1) PSLC was required to recognize gain on the sale of its real property in the year of the sale;[4] (2) PSLC was not entitled to use the cost recovery method of accounting; (3) under the installment method of accounting, which PSLC had elected as an alternative to the cost recovery method, PSLC was required to report a gain in the amount of $464,069 for the taxable year ending May 31, 1979; (4) the $464,069 sum was a capital gain to PSLC in the taxable year ending May 31, 1979; (5) PSLC was a "personal holding company" because more than sixty percent of its adjusted ordinary gross income was from interest because the $464,069 was a capital gain and not ordinary income, and (6) inasmuch as PSLC was a personal holding company it owed an additional $106,832 under the personal holding company tax imposed by I.R.C. § 541.

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[4] In the Tax Court opinion the judge refers to the gain on the sale of Summit House by PSLC as being on a sale to MORC but the parties refer to it as being on the sale to PSA and therefore, in effect, being *of* MORC. Thus, PSLC in its brief, in an assertion that the Commissioner does not challenge, indicates that "the Commissioner determined that PSLC realized a capital gain of $3,742,704 from its sale of Summit House to PSA of which $464,069 was recognizable in PSLC's taxable year ending May 31, 1979, because of the application of the installment method. Although PSLC's sale was of the stock of MORC, the Commissioner computed the gain as if PSLC had sold Summit House to PSA" for $7,759,200. Elsewhere, however, PSLC refers to the $464,069 as "income realized on the sale of real property to its subsidiary by PSLC. . . ." We will not linger on this point as all of the transactions we have described were clearly part of a related program. Furthermore, the parties do not treat the question of which transfer was taxed as significant. We do note that the size of the gain suggests that the transfer to PSA was taxed. We also point out that it was not simply the Commissioner who determined that there was a gain of $3,742,704, as suggested in the quotation, for PSLC reported that gain on its tax return.

C. *The Assessment of Deficiencies Against the Prussins*

The Prussins reported a loss of $417,012 from George Prussin's distributive share of the 1978 losses of PSA on their joint federal income tax return for 1978, and a loss of $345,170 from George Prussin's distributive share of PSA's 1979 losses on their 1979 income tax return. On April 22, 1985, the Commissioner issued a deficiency notice to the Prussins entirely disallowing his share of the partnership losses on the ground that the Prussins had not established the amount and character of any of the partnership items on which their individual loss claims were based.

D. *This Litigation*

PSLC and the Prussins brought these actions challenging the Commissioner's deficiency notices. Prior to the consolidated trial, PSLC conceded all issues other than its status as a personal holding company. A trial then ensued before Judge Cohen of the United States Tax Court whose opinion is reported as *Pleasant Summit Land Corporation v. Commissioner,* T.C.M. (CCH) 1987-469 at 566-76 (Sept. 17, 1987) [hereinafter *PSLC*]. Judge Cohen held that PSLC qualified as a personal holding company subject to the personal holding company tax and, accordingly, she upheld the Commissioner's assessment of a $236,840 deficiency for PSLC's taxable year ending May 31, 1979. On this appeal PSLC challenges the Tax Court's finding that PSLC was a personal holding company, though it does not contend that, if it was a personal holding company, the assessment was erroneously calculated.

Judge Cohen determined that the Prussins had deficiencies for their taxable years ending December 31, 1978, and December 31, 1979, respectively, of $264,571.00 and $141,496, attributable to her sustaining the disallow-

ance of deductions that PSA passed through to its limited partners including the Prussins.[5] The disallowance of PSA's deductions was based on Judge Cohen's factual finding that the nonrecourse debt underlying its purchase of Summit House was greater than its fair market value, which did not exceed $4,200,000. The judge held that as a matter of law nonrecourse indebtedness in excess of fair market value would not support deductions for either depreciation or interest payments as there was no investment in the property and no genuine indebtedness for its purchase. She explained that no depreciable basis in Summit House had been established and consequently no portion of the nonrecourse indebtedness would support tax deductions. On appeal the Prussins challenge Judge Cohen's findings of fact, her application of legal standards, and the constitutionality of the legal standards applied.

II. THE STANDARDS OF REVIEW

This court has plenary review of the Tax Court's construction of the Internal Revenue Code. *See Minizza v. Stone Container Corp.*, 842 F.2d 1456, 1459 (3d Cir. 1988); *Creque v. Luis*, 803 F.2d 92, 93 (3d Cir. 1986). This standard of review applies with regard to three issues on appeal. First, it is a question of law whether a single factor test or a multiple factor analysis is employed to determine if a property is held primarily for sale to customers in the ordinary course of a taxpayer's trade or business. Second, it is a question of law whether nonrecourse indebtedness in

[5] In its brief, the Commissioner indicates that the deficiencies were $229,842.80 and $138,112.50. These figures come from the decision of the Tax Court rather than the opinion. On the record before us, we cannot account for this discrepancy but are not required to do so as the deficiencies will in any event be recalculated.

excess of fair market value may support depreciation and interest deductions. Third, it is a question of law whether deductions based on such indebtedness should be completely disallowed when a taxpayer fails to meet his burden of proof of the fair market value of the property.

The Tax Court's conclusion that the nonrecourse indebtedness on the underlying transaction exceeded the fair market value of Summit House was a finding of fact subject to review for clear error only. *See Anderson v. Bessemer City*, 470 U.S. 564, 573-76, 105 S.Ct. 1504, 1511-12 (1985); *Commissioner v. Duberstein*, 363 U.S. 278, 289, 80 S.Ct. 1190, 1198-99 (1960); *B.B. Rider Corp. v. Commissioner*, 725 F.2d 945, 948 (3d Cir. 1984).

PSLC argues that while factual findings are generally subject to review under the clearly erroneous standard, the Tax Court finding that the underlying transaction was not of property held primarily for sale to customers within the ordinary course of its trade or business, constituted an "ultimate fact" subject to plenary review. The Commissioner, however, urges that we accept this finding unless it was clearly erroneous. We have indicated that we no longer recognize the ultimate fact exception to the standard that factual findings are reviewed only for clear error. *American Home Products Corp. v. Barr Laboratories, Inc.*, 834 F.2d 368, 370 n.2 (3d Cir. 1987). Further, the Supreme Court has rejected the ultimate fact exception and has stated that the clearly erroneous standard applies to findings of ultimate fact. *See Pullman-Standard v. Swint*, 456 U.S. 273, 285-90, 102 S.Ct. 1781, 1788-91 (1982). Thus, our earlier decisions permitting plenary review of ultimate fact determinations, *see, e.g., Jersey Land & Development Corp. v. United States*, 539 F.2d 311, 315 (3d Cir. 1976); *Pennroad Corp. v. Commissioner*, 261 F.2d 325, 328 (3d Cir. 1958), *cert. denied*, 359 U.S. 958, 79 S.Ct. 797 (1959), cannot be taken to represent

the present position of this court. Therefore, to the extent that the Tax Court's conclusion regarding the character of the underlying transaction was predicated on a factual finding, it must be accepted unless clearly erroneous. We add, however, that even under a plenary standard of review we would reach the same conclusion as the Tax Court on this issue. Finally, we point out that PSLC contends that, as a matter of law, the undisputed facts require a reversal of the finding in the Tax Court that the sale of Summit House was not of a property held primarily for sale to customers in the ordinary course of PSLC's trade or business. Thus, as we make a plenary determination of legal issues, the dispute over the standard of review is of limited significance in this case.

III. PSLC's APPEAL

Determination of whether PSLC was properly held to be a personal holding company turns solely on whether Summit House was "property held by [PSLC] primarily for sale to customers in the ordinary course of [its] trade or business" within I.R.C. § 1221(1). The Tax Court's opinion provided a clear explanation of the purpose of the personal holding company tax which we need not repeat. We do note that the personal holding company tax is imposed on all corporations satisfying a mechanical test of objective factors which the Tax Court explained in detail.

A. *The Mechanical Test of the Personal Holding Company Tax*

Section 541 of the Internal Revenue Code imposes an additional tax on undistributed personal holding company income, as defined in section 545, for "every personal holding company (as defined in section 542)." Section 542(a) provides that any corporation is a personal holding company if it meets mechanical tests relating to the

number of stockholders and to the character of income earned during the tax year. Inasmuch as all PSLC stock was owned by one person, PSLC agrees that the stockholder test was met and thus we do not describe that test in detail.

The character of income requirement is contained in section 542(a)(1), which provides that "[a]t least 60 percent of [the corporation's] adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year [must be] personal holding company income (as defined in section 543(a))." This may be expressed as follows: a corporation is a personal holding company if the fraction consisting of personal holding company income as the numerator and adjusted ordinary gross income as the denominator is greater than or equal to sixty percent (60%). Our task in establishing this fraction is simplified by the circumstance that during its applicable tax year PSLC had only two kinds of income, income from interest payments on debts arising from the Summit House transactions and income from the sale of the Summit House property.

Inasmuch as the parties agree that only the interest payments constituted personal holding company income, the numerator of the fraction is not in dispute. They disagree, however, over calculation of the denominator of the fraction. If the gain from the sale of Summit House is included in the denominator then PSLC is not a personal holding company. But if the gain is excluded then only the interest income is included in both the numerator and the denominator, giving the fraction a value of one or 100% and, since 100% is greater than 60%, PSLC is a personal holding company.

B. ***Calculation of the Denominator***

The denominator of the fraction consists of "adjusted ordinary gross income (as defined in section 543(b)(2))."

I.R.C. § 542(a)(1). Section 543(b)(2) defines adjusted ordinary gross income as "ordinary gross income" subject to certain reductions not applicable to this case.

"Ordinary gross income" is defined by section 543(b)(1)(A) as gross income less "all gains from the sale or other disposition of capital assets."[6] A "capital asset" is defined by section 1221 to include all property of a taxpayer subject to certain specific exceptions. PSLC argues that the exception for "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" applies to the Summit House. I.R.C. § 1221(1).

C. *Whether the Sale was Within the Ordinary Course of Trade or Business*

While the Commissioner recognizes that a pre-trial stipulation provided that PSLC held Summit House exclusively for sale, he contends that the sale was not of an asset primarily held for sale within the ordinary course of PSLC's trade or business. A determination that PSLC's sale of Summit House was not within the ordinary course of its trade or business would result in the exception of section 1221(1) not applying and, inasmuch as PSLC has not argued that any other exception applies, the general rule of section 1221 would govern. Thus, Summit House would be deemed to be a capital asset and the gain on its sale would be excluded from both PSLC's ordinary gross income and adjusted ordinary gross income. Consequently, PSLC's interest income would constitute the only element of both the numerator and denominator giving the fraction a value of one or 100% and PSLC would qualify as a personal holding company.

Thus, it is perfectly obvious that the determination of whether PSLC is a personal holding company turns solely

[6] There are other exclusions as well but they are not applicable.

on whether its sale of Summit House was of property held primarily for sale within the ordinary course of its trade or business. PSLC argues that the trial judge's conclusion that its sale of Summit House was not within the ordinary course of its trade or business was clearly erroneous and that, in any event, the Tax Court was required to reach the opposite conclusion as a matter of law.

1. *PSLC's Factual Challenge*

We have held that determination of whether property is held for sale within the ordinary course of a taxpayer's trade or business is a question of fact. *See Jersey Land & Development Corp.*, 539 F.2d at 315; *Juleo, Inc. v. Commissioner*, 483 F.2d 47, 50 (3d Cir.) (Gibbons, J., dissenting), *cert. denied*, 414 U.S. 1103, 94 S.Ct. 737 (1973); *Heebner v. Commissioner*, 280 F.2d 228, 231-32 (3d Cir.), *cert. denied*, 364 U.S. 921, 81 S.Ct. 285 (1960).[7] PSLC argues that the Tax Court's finding was clearly erroneous because it was inconsistent with the pretrial stipulation that PSLC held Summit House exclusively for sale.

The stipulation reads as follows:

> On or about June 1, 1978, PSLC purchased a certain piece of real estate located in West Orange, New Jersey, and certain fixtures, equipment, and other personal property located on or used in connection therewith. . . . *Said purchase was made by PSLC with a view towards immediately reselling the buildings and personalty* to its wholly-owned subsidiary,

[7] The determination of the taxpayer's primary purpose in holding the property is made as of the time of sale. *Jersey Land & Development*, 539 F.2d at 315. Here, the circumstances were such that PSLC's purpose in holding the Summit House could not have changed in the time between when it acquired the property and sold the shares of MORC.

> Mount Orange Realty Corp [MORC]. (Emphasis added.)

PSLC relies on the emphasized portion. This language, however, is not inconsistent with the Tax Court's conclusion that PSLC did not establish that the Summit House transaction occurred within the ordinary course of PSLC's trade or business for it does not even mention the point.

Furthermore, PSLC did not present any evidence as to whether it held Summit House primarily for sale to customers within the ordinary course of its trade or business. Since PSLC bore the burden of proof on this issue, *see* Tax Ct. R.P. 142(a); *Helvering v. Taylor,* 293 U.S. 507, 513-15, 55 S.Ct. 287, 290-91 (1935); *Anastasato v. Commissioner,* 794 F.2d 884, 886-87 (3d Cir. 1986), the Tax Court upheld the Commissioner's determination. Judge Cohen pointed out that "[h]ad petitioner chosen to address the issue at trial, it might have submitted evidence demonstrating that the property was held or sold in the ordinary course of PSLC's trade or business. See section 1221(1). Absent such evidence, we cannot find that the property was not a capital asset. Rules 142(a) and 149(b). Respondent's [Commissioner's] determination is sustained." *PSLC* at 573 (citations omitted).

In summary, the stipulation does not state that the Summit House transaction was within PSLC's ordinary course of trade or business and PSLC offered no evidence that it was. Thus, we hold that the Tax Court's factual finding that the sale was not within the ordinary course of PSLC's trade or business was not clearly erroneous.

2. *PSLC's Legal Challenge*

PSLC nevertheless advances the slightly different argument that, as a matter of law, the stipulated facts required that the Tax Court conclude that sale of Summit House

occurred within the ordinary course of its business. In substance, its argument is that as a matter of law it must be concluded that the purchase of an asset for sale subject to a pre-existing contract of sale *always* results in the acquisition of a property to be held primarily for sale to customers in the ordinary course of trade or business. PSLC argues that the Tax Court erred in failing to follow this single factor approach. If, however, as the Commissioner argues, a court must consider and weigh several factors to make this determination, then PSLC cannot prevail on this theory.

This court addressed the problems involved in determining when a sale occurs during a taxpayer's ordinary course of business in *Jersey Land & Development Corp.*, where we stated:

> Whether or not a taxpayer has held real property for sale to customers in the ordinary course of its business is an issue that has often been litigated in the federal courts. Despite this volume of litigation, however, *there is no fixed formula or rule of thumb to which a court may readily resort for guidance in resolving this issue.* Rather, each case must, by necessity, turn upon its own facts since *this question is, in the final analysis, one of fact to be determined from the totality of the circumstances surrounding each particular case.* [539 F.2d at 315 (emphasis added.)]

This fact-specific approach in *Jersey Land & Development* was consistent with our precedents. *See Heebner v. Commissioner,* 280 F.2d at 232; *Kaltreider v. Commissioner,* 255 F.2d 833, 838 (3d Cir. 1958). The Tax Court has followed this approach and it is now stated that the determination "[w]hether income from the sale of property is excluded from capital gains treatment is a question of fact, the burden of which is on [the taxpayer]." *S & H,*

Inc. v. Commissioner, 78 T.C. 234, 242 (1982); *see Baumgart v. Commissioner*, 47 T.C.M. (CCH) 592, 598, 52 T.C.M. (P-H) 3095, 3101 (1983).

The characterization of the income from the sale of Summit House is a question of fact depending partially on PSLC's intent with respect to its business activities. *See Baumgart*, 47 T.C.M. (CCH) at 596, 52 T.C.M. (P-H) at 3099. Several cases have identified a number of factors to be considered in this analysis.[8] The factors most frequently identified are: (1) the purpose for which the taxpayer acquired and held the property; (2) the extent of improvements made to facilitate its sale; (3) the activity of the taxpayer in promoting the sales; (4) the frequency and continuity of sales; (5) the extent and substantiality of sales; (6) the length of time between purchase and sale; and (7) the relative income to the taxpayer from the sale of the property, compared with his other income. *See Baumgart*, 47 T.C.M. (CCH) at 598, 52 T.C.M. (P-H) at 3101; *S & H*, 78 T.C. at 243 n.12. This court has enumerated and relied on these factors. *See Kaltreider*, 255 F.2d at 838.

PSLC has not cited any controlling authority to suggest that we have departed from this multi-factor analysis. PSLC does, however, cite *S & H*, *Morley v. Commissioner*, 87 T.C. 1206 (1986), *Baumgart*, and *DeMars v. United States*, 71-1 U.S. Tax Cas. (CCH) ¶ 9288, at 86,114, 27 A.F.T.R.2d (P-H) ¶ 71-490, at 71-925 (S.D. Ind. 1968), for the proposition that when a taxpayer purchases real estate for sale to a specific party under a preexisting contract, it holds the property primarily for sale to customers in the ordinary course of business regardless of other factors or facts.

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[8] This court has observed, however, that while these factors may be helpful in analyzing residential real estate transactions, they are of limited utility when commercial real estate is involved. *See Jersey Land & Development*, 539 F.2d at 316.

S & H and *Morley* do not stand for the stated proposition. Like our case, those cases involved a taxpayer's single venture and determination of whether the property involved was held primarily for sale to customers within the ordinary course of the taxpayer's trade or business. *S & H* and *Morley* merely rejected adoption of an absolute prohibition precluding the court from determining that a unique undertaking was within the scope of the taxpayer's trade or business with respect to that single transaction. As *Morley* explained, *S & H* "rejected the so-called 'one-bite' rule to the extent that such rule established that 'a taxpayer who engaged only in one venture or one sale *cannot under any circumstances* be held to be in a trade or business as to that venture or sale.' " *Morley,* 87 T.C. at 1211 (*citing S & H,* 78 T.C. at 244 (emphasis added)). By rejecting a *per se* rule, the Tax Court in *Morley* and *S & H* reaffirmed that this is an issue of fact in which no one fact or factor is dispositive. *See Morley,* 87 T.C. at 1213.

DeMars and *Baumgart,* however, do go further and state a *per se* rule, "that property acquired for the purpose of sale to a specific party pursuant to a pre-existing arrangement constitutes property held for sale in the ordinary course of a trade or business." *DeMars,* 71-1 U.S. Tax Cas. (CCH) ¶ 9288 at 86,117, 27 A.F.T.R.2d (P-H) ¶ 71-490, at 71-929. We, however, decline to follow these cases as we have previously stated that "[n]o single factor or test is dispositive." *Kaltreider,* 255 F.2d at 838. Thus, we reaffirm our conclusion that whether a property is held primarily for sale to customers within the ordinary course of a taxpayer's trade or business is a fact specific question for which no single factor is dispositive. Here the finding of fact by the Tax Court on the issue was not clearly erroneous and thus must be upheld. In any event, on an independent review of the record we would reach the same result because of the lack of evidence that the transaction

involved a property held primarily for sale to customers in the ordinary course of PSLC's trade or business. Thus, we will affirm the judgment of the Tax Court on PSLC's appeal.

IV. THE PRUSSINS' APPEAL

The Prussins, as limited partners in PSA, claimed a deduction for the distributive share of PSA's depreciation and interest deductions which the Commissioner, upheld by the Tax Court, completely disallowed. Three issues are raised with respect to the Tax Court's decision on this point. First, we consider whether PSA's purchase of Summit House, and not the individual limited partners' investment in PSA, is the appropriate transaction for examination. Second, we must decide whether the Tax Court's finding of fact that PSA's nonrecourse indebtedness substantially exceeded the fair market value of Summit House was clearly erroneous. Third, we must consider which of the following approaches should be followed: (1) the excess nonrecourse indebtedness may support the claimed deductions; (2) the presence of excess nonrecourse indebtedness requires a complete disallowance of the claimed deductions; or (3) only deductions attributable to the nonrecourse indebtedness to the extent that it was excessive should be disallowed.

A. *The Relevant Inquiry Takes Place at the Partnership Level*

The Prussins urge that we consider the transaction from the perspective of the individual limited partners who did make substantial cash contributions for their investments. But a partnership is required to file its own federal income tax return. Accordingly, for the purpose of computing income and deductions, "the partnership is regarded as an independently recognizable entity apart from the aggre-

gate of its partners." *United States v. Basye,* 410 U.S. 441, 448, 93 S.Ct. 1080, 1085 (1973); *accord Brannen v. Commissioner,* 722 F.2d 695, 703 (11th Cir. 1984). After the partnership's income and deductions are calculated and reported it is a conduit through which income and deductions are distributed to individual partners. *See Brannen,* 722 F.2d at 703; *Goodwin v. Commissioner,* 75 T.C. 424 (1980), *aff'd without published opinion,* 691 F.2d 490 (3d Cir. 1982). Thus, inasmuch as the Prussins claim losses from the Summit House transaction because of George Prussin's limited partnership interest in PSA, we must make our analysis of the investment from the point of view of the partnership. *See Simon v. Commissioner,* 830 F.2d 499, 506-07 (3d Cir. 1987). This conclusion renders immaterial the Prussins' argument which, predicated on the investment of the limited partners, is that this transaction should be regarded as an at risk rather than a nonrecourse transaction.

B. *Whether PSA's Nonrecourse Indebtedness Exceeded the Fair Market Value of Summit House*

If we assume, even though the record is unclear on this point, that PSA paid the $500,000 which MORC was to have paid to PSLC, PSA's purchase price for Summit House was $7,759,200, of which no more than $500,000 was paid other than by creation of nonrecourse indebtedness. Otherwise it was $7,259,200. It is this investment which must be compared to the fair market value of Summit House.

The Prussins challenge Judge Cohen's finding of the maximum fair market value. At trial they had the burden of proof on the issue. Tax Ct. R.P. 142(a); *see Helvering v. Taylor,* 293 U.S. at 513-15, 55 S.Ct. at 290-91; *Anastasato v. Commissioner,* 794 F.2d at 886-87. But they

introduced no significant evidence of valuation and they produced no expert testimony on this point.[9]

While normally the parties to a real estate transaction have adverse economic interests and thus can be expected to establish fair market value themselves, Judge Cohen explained that here "[s]ales subsequent to PSLC's acquisition of the property . . . were not at arm's length, and provide no evidence of the property's fair market value." *PSLC* at 575. This determination rested on her perception of the motivation for the conveyances: "in a transaction entered into primarily to generate tax benefits, the interests of the buying and selling parties are not necessarily adverse." *PSLC* at 575.

The Prussins challenge this line of reasoning by asserting that not paying money out is almost *always* better than getting a deduction. Thus, PSA would not pay an excessive amount for the property. While their reasoning is generally true, the Tax Court cited PSA's own projected tax benefits to demonstrate that this transaction did indeed provide deductions sufficient to compensate for the additional money paid out. *See PSLC* at 570. In addition, there was no evidence that PSA had attempted to negotiate the sale price. We conclude that Judge Cohen was justified in considerating indications other than what PSA paid to determine the fair market value of Summit House.

The Tax Court did consider the following indicia of fair market value: (1) PSLC had paid $4,200,000 for the improvements *and the land* in an arms length transaction immediately before selling the improvements to PSA for over $7,700,000, *see PSLC* at 573-76; (2) the assessed value of

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[9] Judge Cohen observed that Tax Court Rule of Procedure 143(f) and a pretrial standing order required the taxpayers to present an expert report but that the taxpayers decided to forego expert testimony on the value of Summit House. *See PSLC* at 574 & n.6.

the improvements for property tax purposes suggested a fair market value of $1,522,500;[10] (3) the improvements were insured for $2,745,000;[11] and, (4) the improvements and land were sold in 1985 for $7,000,000.

The Prussins argue that the Tax Court erroneously ignored oral testimony regarding the anticipated increase in value of Summit House provided it could be marketed as originally envisioned as cooperatives or condominiums, a purpose frustrated by a change of local law. We, however, see no reason to accept this assertion in view of Judge Cohen's analysis of the evidence in the record. Further, the facts of this case demonstrate the peril in relying on anticipated changes in a property to support an enhanced value. In short, Judge Cohen did not have to reject solid evidence showing a maximum fair market value because of a speculative projected new use.

The Prussins erroneously assert that Judge Cohen held that PSLC's purchase price was conclusive of fair market value in PSA's subsequent purchase. She, however, did not hold that Summit House could be worth no more to PSA than PSLC had paid for the property. What she did hold was that the Prussins had failed to meet their burden of proof on value and that only the sale to PSLC on the record provided evidence of the value of Summit House. Furthermore, she did not find that fair market value was

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[10] The Tax Court relied on the assessed value and the municipality's stated relationship between the assessed value and fair market value. The assessed value had been presented by PSA to its investors in its initial offering memorandum. *See PSLC* at 575. Judge Cohen considered and rejected the Prussins' contention that PSLC's purchase price was for less than the fair market value. This finding was not clearly erroneous.

[11] The replacement value of the buildings, not the land, was insured for this value under a policy containing a 90 percent coinsurance clause. *See PSLC* at 574.

$4,200,000; she concluded that fair market value could not have been more than that sum. *See PSLC* at 575.

Given her consideration of many different bases for finding fair market value and the Prussins' failure to present expert testimony on value, we conclude that Judge Cohen's findings as to the maximum fair market value were not clearly erroneous. Accordingly, we will not disturb her finding that the nonrecourse financing exceeded the fair market value of Summit House.

C. *The Appropriate Legal Standard*

The Internal Revenue Code does not expressly provide in any section germane to this case for any adjustment of deductions when nonrecourse debt exceeds fair market value.[12] Thus, it is necessary to analyze the overall statutory framework and legal precedents to understand the significance of the Tax Court's finding that PSA's nonrecourse debt exceeded the fair market value of Summit House.

1. *The Statutory Framework*

The Internal Revenue Code allows a deduction for "a reasonable allowance for the exhaustion, wear and tear" of property used in the taxpayer's trade or business and of property held for the production of income. I.R.C. § 167(a). This depreciation deduction is calculated using the adjusted basis of the property used to calculate gain under section 1011. *See* I.R.C. § 167(g). The basis of the property for purposes of calculating gain under section 1011 is ultimately defined in section 1012. Section 1012

[12] The at risk provisions of the Internal Revenue Code of 1954 do not govern this case. *See* I.R.C. § 465 as amended by the Revenue Act of 1978, Pub. L. No. 95-600, § 201, 92 Stat. 2763, 2814-15 (1978).

provides that generally the "basis of property shall be the cost of such property."

The cost of property includes the amount of indebtedness incurred or assumed by the purchaser as part of the purchase transaction. *See Crane v. Commissioner,* 331 U.S. 1, 9-10, 67 S. Ct. 1047, 1052-53 (1947). However, several courts of appeals have held that nonrecourse debt in excess of fair market value is not included in the cost of property for purposes of calculating the depreciation deduction. *See, e.g., Odend'hal v. Commissioner,* 748 F.2d 908, 912-14 (4th Cir. 1984), *cert. denied,* 471 U.S. 1143, 105 S.Ct. 3552 (1985); *Estate of Franklin v. Commissioner,* 544 F.2d 1045, 1049 (9th Cir. 1976).

Section 163(a) of the Internal Revenue Code allows a deduction for all interest paid or accrued within the taxable year on indebtedness. This provision allows a deduction for interest paid on nonrecourse debt. It has been held, however, that when "both the purchase price and the lesser principal amount of the nonrecourse note which makes up a portion of such purchase price unreasonably exceed the value of the property acquired, then no 'genuine indebtedness' exists and no 'investment in the property' occurs." *Flowers v. Commissioner,* 80 T.C. 914, 942 (1983); *see also Odend'hal,* 748 F.2d at 912-14; *Estate of Franklin,* 544 F.2d at 1049.

Although separate statutory provisions govern interest and depreciation deductions, the case law typically merges issues relating to their allowance. Thus, when nonrecourse debt is excluded from the basis for purposes of calculation of depreciation, it is not treated as genuine indebtedness for determination of interest deductions.

2. *Whether the Nonrecourse Indebtedness is Included In PSA's Basis and Whether it is "Genuine Indebtedness"*

Although this court has not previously addressed this issue,[13] decisions of other courts of appeals have disallowed deductions for interest and depreciation in circumstances similar to those here. Some of these cases specifically involve investments in real estate and improvements.[14]

Of the cases decided by other courts of appeals, that most similar to this case is *Odend'hal v. Commissioner,* 748 F.2d 908. *Odend'hal* stands for the proposition that if the fair market value of property is less than its nonrecourse financing, the principal of the nonrecourse financing in excess of fair market value is not included in the basis for the purpose of claiming depreciation. Moreover,

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[13] In *CRC Corp. v. Commissioner,* 693 F.2d 281 (3d Cir. 1982), *cert. denied,* 462 U.S. 1106, 103 S.Ct. 2453 (1983), we held that we would not require the Commissioner to permit contingent or speculative obligations to be included in the basis while the uncertainty surrounding them was unresolved. *CRC,* like *Brountas v. Commissioner,* 692 F.2d 152 (1st Cir. 1982), *cert. denied,* 462 U.S. 1106, 103 S.Ct. 2453 (1983), and *Gibson Products Co. v. United States,* 637 F.2d 1041 (5th Cir. 1981), on which it relied, should thus be regarded as timing cases and, while wholly consistent with our result, are not sufficient authority on which to base our decision.

[14] The Prussins argue that cases involving wasting assets are inapplicable to real estate investments. The Prussins rely on *Siegel v. Commissioner,* 78 T.C. 659, 690 (1982), to demonstrate that the Tax Court recognizes the distinction between wasting assets and realty when determining whether excess debt should be added to basis. *Siegel* involved a limited partnership investment in a motion picture and thus to the extent it addresses the treatment of real estate, the portion of *Siegel* relied on by the Prussins is dictum. The actual holding of *Siegel* is not inconsistent with our result but even if it was we would not be bound by it.

Odend'hal holds this excess nonrecourse debt does not sustain a deduction for interest payments.

The facts of *Odend'hal* were as follows. Ten taxpayers purchased a warehouse and food processing facility. As in this case, the taxpayers acquired only the improvements and a long term lease on the land.[15] The purchase took place in December of 1972 for a total consideration of $4,000,000 of which $80,000 was paid in cash and $3,920,000 was financed by nonrecourse debt. Interest on the nonrecourse debt was to be serviced currently but the principal was due in a balloon payment at the end of a fifteen year period.

The promoter of this investment represented that based on a depreciable lifespan of fourteen-and-a-half years, the income earned from leasing the property would not equal the total of the cost of leasing the land, mortgage interest, and depreciation. However, he explained that the interest and depreciation deductions would generate additional tax benefits so that an investor in the 50% tax bracket would convert the investment income loss into an after-tax gain.

Although the taxpayers purchased the property for $4,000,000, the Tax Court concluded that its fair market value was only $2,000,000. Because of the wide discrepancy between the face value of the nonrecourse debt and the fair market value, the Tax Court held that the nonrecourse note did not represent genuine indebtedness. Thus, it did not allow the taxpayers to include the nonrecourse debt in their basis for purposes of depreciation. In addition, the taxpayers were allowed to deduct interest and other expenses only to the extent of their income from the property.

The taxpayers appealed to the United States Court of Appeals for the Fourth Circuit, arguing that the Tax

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[15] The lease at the lessees' option was for 99 years. Here it was for 90 years.

Court's determination of fair market value was clearly erroneous and that, as a matter of law, the Tax Court was bound to recognize the entire nonrecourse indebtedness when computing depreciation and interest deductions. The Court of Appeals rejected both contentions.

In finding that the Tax Court's valuation of the property was not clearly erroneous, the Court of Appeals relied, in part, on the fact that the same property had been conveyed for $2,670,000 in an arm's length sale five years before it was sold to the group of ten taxpayers. *See id.* at 911-12. Once the fair market value was established the court turned to the issue of the excessive nonrecourse debt. It stated:

> If, as a matter of fact, the fair market value of the property is less than that financed by a nonrecourse loan, the authorities hold that the principal of the nonrecourse loan which exceeds fair market value does not represent a real investment in the property by a taxpayer and he may not include that nonrecourse amount in his basis for depreciation. In addition, the interest paid on the loan is not allowable as an interest deduction. Basis for depreciation usually includes the amount of any indebtedness incurred or assumed by the purchaser in connection with the purchase of the property, because the taxpayer has an obligation to pay the debt. When the debt is a nonrecourse loan, the principal amount of the loan is included in the taxpayer's basis so long as the fair market value of the property is at least equal to the amount of the nonrecourse debt at the time it was incurred, because the taxpayer, even though he has no personal liability at stake, has an economic incentive to pay off the debt rather than to lose the collateral. But if the stated price financed by nonrecourse debt

> exceeds the fair market value of the property, to the extent of the excess, the taxpayer has no equity in the property to protect and no economic incentive to pay off the debt. [*Id.* at 912.] (Citations omitted.)

Under this analysis taxpayers are able to claim depreciation and interest deductions to the extent that nonrecourse debt does not exceed fair market value.

Odend'hal ultimately relied on *Estate of Franklin,* 544 F.2d 1045, which imposed similar limits on deductions supported by nonrecourse debt. In *Estate of Franklin* the owner of a motel agreed to sell it for $1,224,000 with the entire purchase price to be paid by a note secured by a nonrecourse mortgage with monthly principal and interest installments of $9,045.36. A balloon payment of $975,000 was due ten years from the sale. The property was leased back to the seller for a monthly rental equal to the $9,045.36 monthly debt service. The seller was responsible for operating the motel and paying all expenses. The buyers' only cash payment was $75,000 of prepaid interest.

The buyers claimed that they could take interest and depreciation deductions for the ten years and then either make the balloon payment and complete the purchase or back out of the purchase. The Tax Court characterized this transaction as a ten year option to purchase and accordingly disallowed the deductions for interest and depreciation.

The Court of Appeals for the Ninth Circuit considered the case from a different perspective. It held that if the transaction met two criteria it would not be considered a sale for tax purposes and thus no interest or depreciation deductions would be allowed. The first test was whether the value on which the transaction was based exceeded the fair market value of the property. The second factor was whether the transaction was financed with nonrecourse

debt which exceeded the fair market value of the underlying property. The Court of Appeals concluded that the transaction in *Estate of Franklin* met these two criteria and thus it affirmed the Tax Court.

The Prussins attempt to distinguish *Odend'hal* and *Estate of Franklin* on two rationales. First, they argue cash represented only three percent of the purchase price in *Odend'hal* and just over six percent of the purchase price in *Estate of Franklin,* as opposed to their own more substantial investment in PSA. Second, they contend the large balloon payments in *Odend'hal* and *Estate of Franklin* demonstrate that the transactions were mere options to purchase and that here there are no such balloon payments.

Each of these attempts to distinguish *Odend'hal* and *Estate of Franklin* must fail. With regard to the first objection, the appropriate comparision with *Odend'hal* and *Estate of Franklin* is the proportion of cash to nonrecourse debt paid by PSA rather than the amount of the individual limited partners' cash investments. Based on a purchase price of $7,759,200 and a $500,000 cash payment, assuming it was made, this calculation would indicate that 6.44% of the purchase price was paid in cash. This analysis reveals the similarity of this case to the precedents rather than providing a basis to distinguish them. Of course, the Prussins' argument is even weaker if the $500,000 was not paid.

The Prussins' second rationale partially misstates the terms of PSA's obligations. As we have indicated, principal payments on the mortgages were substantially postponed.[16] But even if they were not, it is the existence of

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[16] We have so concluded on the basis of our study of notes and mortgages in the record. We point out, however, that the Commissioner makes no mention of this point in his brief.

deferred nonrecourse indebtedness in excess of the value of the property that creates the economic disincentive to pay the debt. While there may be less incentive to make a balloon payment at the end of a term as compared with earlier structured payments, the proper analysis must be predicated on a comparison of the nonrecourse debt to the fair market value of the property at its acquisition.

The Prussins attempt to distinguish other cases applying *Estate of Franklin* to real estate investments. Both *Beck v. Commissioner,* 678 F.2d 818 (9th Cir. 1982), and *Narver v. Commissioner,* 75 T.C. 53 (1980), *aff'd per curiam,* 670 F.2d 855 (9th Cir. 1982), are supposedly inapplicable in light of the small percentage of the purchase price paid in a form other than nonrecourse debt and the great overvaluing of the property. But the Prussins' attempt to distinguish these cases must fail for the same reason that *Odend'hal* and *Estate of Franklin* cannot be distinguished: that is, the Prussins are not comparing the same parts of the different transactions as they are looking to the limited partners' investment rather than that of PSA. The Summit House purchase price was substantially paid by PSA with nonrecourse obligations.[17]

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[17] The Prussins challenge the entire *Estate of Franklin* line of cases by pointing out that inasmuch as this is a limited partnership case, the Commissioner's reliance on the nonrecourse aspect of the transaction is "completely misplaced" as the limited partners were not liable anyway. We do not agree, because the legal insulation of the limited partners in no way would impact on the incentive of the general partner to pay a recourse obligation. Thus, their argument on this point incorrectly looks at the transaction from the wrong perspective. As we have indicated, the relevant inquiry takes place at the partnership level. Their argument may actually cut the other way as in a limited partnership recourse note situation it could be contended that the *Estate of Franklin* rationale should be followed if the debt is excessive as compared to the value of the property and the general partner is not financially responsible.

While we regard *Odend'hal* and *Estate of Franklin* as the appropriate precedents, we do not consider them as authority to eliminate all deductions for interest and depreciation. While we realize that a taxpayer holding property subject to a nonrecourse debt in excess of the market value of the property may have no incentive to pay off any portion of the debt, including the amount not exceeding the fair market value of the property, it is equally logical to recognize that the creditor holding the debt has no incentive to take back the property if the taxpayer offers to pay the debt up to the value of the property. For example, if a creditor held a nonrecourse debt for $1,500,000 on a property with a fair market value of $1,000,000, he would have a disincentive to foreclose if his defaulting debtor offered to settle the debt for not less than $1,000,000. Thus, it is appropriate to disregard only the portion of nonrecourse debt in excess of the fair market value of the property when it was acquired for purposes of calculations of the depreciation and interest deductions and to regard the nonrecourse debt as genuine indebtedness to the extent it is not disregarded. Moreover, there is precedent for disallowing deductions based on nonrecourse debt only insofar as attributable to the excess of debt over the fair market value. *See Odend'hal,* 748 F.2d at 912-14.

Unquestionably, the record compels the conclusion that Summit House, though not exceeding $4,200,000 in fair market value, had a substantial value. Thus, under our analysis the Tax Court's determination that the deductions should be disallowed in full cannot be sustained. Accordingly, we will remand the case to the Tax Court for a determination of fair market value of Summit House at the time of PSA's acquisition.[18]

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[18] While Judge Cohen indicated that "the fair market value of the property could not have been more than $4,200,000," *PSLC* at 575,

We also conclude that the actual cash investment of PSA in the purchase of Summit House, if there was any, should be disregarded in the calculation of the fair market value as it obviously was at risk. While Judge Cohen inferred that the $500,000 was not paid by PSA, we are not satisfied that this was necessarily correct, particularly in view of the Commissioner's brief in which it is recited that it appears that the $500,000 was paid from the investor's funds. According to the Prussins, the absence of evidence establishing that the $500,000 was paid is attributable to the fact that there was no issue at trial raised regarding this point. On the remand it may be definitively ascertained whether the payment was made. The significance of the cash investment is that there is an economic reason to pay off a nonrecourse debt when there is some equity in the property, even though the total debt when added to the equity exceeds the value of the property, as the alternative to paying the debt is the loss of the equity. Thus, if there is a $500,000 equity in a property worth $4,000,000, the owner of the property should logically be willing to pay off up to $4,000,000 in nonrecourse debt to save the property because his loss in that case will not exceed $500,000 but his loss in giving up the property will be $500,000.

The Prussins' constitutional challenge is based on a contention that they were denied due process of law by the

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she may have concluded that it was $4,200,000, though her opinion does not include a definitive finding on the point. We, however, doubt that she did intend to determine the fair market value as distinguished from the maximum fair market value, as the $4,200,000 figure came from the price to PSLC which included the land and improvements and PSA by purchasing MORC acquired only the improvements. If, however, we misunderstand her findings on this point, the fair market value need not be reconsidered. We also point out that while we are remanding the case for calculation of the fair market value, the Prussins will be limited to a maximum value of $4,200,000, as we are upholding the finding that the fair market value did not exceed that figure.

total disallowance of the deductions. Thus, they do not assert that the result we reach would deny them due process of law. Accordingly, their constitutional argument is moot and will not be considered.

V. CONCLUSION

In summary, we hold that PSLC failed to establish that it held Summit House primarily for sale to customers in the ordinary course of its trade or business. Hence, the decision of the Tax Court with respect to PSLC will be affirmed. We hold that the Tax Court's finding that PSA's nonrecourse debt exceeded the fair market value of Summit House was not clearly erroneous and will not be disturbed. We also hold that PSA's nonrecourse debt did not support interest and depreciation deductions to the extent it exceeded the sum of the cash investment of PSA in Summit House and the fair market value of Summit House at the time of its purchase. We will partially reverse the decision as to the Prussins and will remand the matter to the Tax Court for a determination of the fair market value of Summit House, the actual cash investment, if any, made by PSA for the purchase of Summit House, and for further proceedings consistent with this opinion which will partially allow the interest and depreciation deductions claimed by them.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 88-1377

GEORGE PRUSSIN AND SHARON PRUSSIN, APPELLANTS

v.

COMMISSIONER OF INTERNAL REVENUE

Tax Court No. 28283-85

On Petition for Rehearing

BEFORE: HIGGINBOTHAM, MANSMANN, AND GREENBERG,
Circuit Judges

(Filed January 30, 1989)

OPINION

GREENBERG, Circuit Judge

The Commissioner filed a petition urging this panel of the court to reconsider our opinion filed on November 25, 1988. Although we will deny the petition we will address several of the Commissioner's arguments.

As framed by the Commissioner the issue meriting rehearing is:

> Whether a taxpayer who has acquired property subject to nonrecourse indebtedness that is far larger than the fair market value of the property at the time of acquisition is entitled to deductions for interest and depreciation attributable to the nonrecourse indebtedness to the extent of the fair market value of the collateral.

Our opinion answered this question in the affirmative.

The Commissioner petitions for reconsideration on two bases. First, he objects to our reading of several precedents upon which we rely as persuasive authority. Second, the Commissioner argues that our opinion will create valuation problems which will produce intolerable administrative burdens.

The Commissioner's first argument refers to our reliance on *Odend'hal v. Commissioner,* 748 F.2d 908 (4th Cir. 1984), *cert. denied,* 471 U.S. 1143, 105 S.Ct. 3552 (1985) and *Estate of Franklin v. Commissioner,* 544 F.2d 1045 (9th Cir. 1976). He argues that the courts in these cases disallowed *any* depreciation or interest deductions rather than disallowing only deductions attributable to the excess nonrecourse debt. Accordingly, he contends that we should disregard the language in each of the opinions suggesting the contrary result.

We observe, however, that in both *Odend'hal* and *Estate of Franklin,* as the Commissioner seems to acknowledge, the issue of whether the taxpayers were entitled to a partial deduction was apparently not raised either before the Tax Court, *see Odend'hal v. Commissioner,* 80 T.C. 588, 590, 602-05, 617-18 (1983); *Estate of Franklin v. Commissioner,* 64 T.C. 752, 760-62, 770-71 (1975), or on appeal, *see Odend'hal,* 748 F.2d at 909, 912,

913; *Estate of Franklin,* 544 F.2d at 1046, 1048-49. In this case the issue was squarely presented to the court, and thus we were required to rule on it. We found the opinions and reasoning in *Odend'hal* and *Estate of Franklin* persuasive while we found their holdings, which did not directly address this issue, not in opposition. Indeed, the Commissioner acknowledges in his petition for rehearing that "[t]o be sure, there is language in the opinions in both *Odend'hal* and *Estate of Franklin,* which, taken out of context, could be read as consistent with the panel opinion here."

The Commissioner's second argument is based on a misreading of our opinion. The Commissioner correctly notes that we call "for the taxpayers to use the fair market value of the property on the date of purchase in determining how much of the nonrecourse debt to allow in calculating their basis in the property." However, the Commissioner suggests that we would allow annual recalculations of the portion constituting genuine indebtedness "because [the taxpayers] have an incentive to repay a greater amount of the nonrecourse debt each year." Accordingly, the Commissioner observes that these recalculations would impose administrative burdens and product "computational anarchy". We cannot perceive how the Commissioner arrived at this understanding as we said that "it is appropriate to disregard only the portion of nonrecourse debt in excess of the fair market value of the property *when it was acquired* for purposes of the depreciation and interest deductions and to regard the nonrecourse debt as genuine indebtedness to the extent it is not disregarded." (Slip op. at 32; emphasis added.) We never suggested that there would be annual reevaluations. Thus, the administrative burdens which the Commissioner contemplates do not exist. However, to clear up any possible misunderstanding, we now expressly state that our opinion of November 25, 1988, is

not to be read to require periodic recalculations of the sum of nonrecourse debt constituting genuine indebtedness.

The Commissioner argues in support of his second basis for rehearing that "a borrower whose note exceeds a reasonable estimate of the fair market value of the property has no immediate incentive to pay off any part of the note, because his payments will not give him any equity in the property unless and until the value of his interest exceeds the face amount of the note." In this regard the Commissioner points out that "the investor's entitlement to the claimed tax benefits" is fixed at the time the property is acquired. But if the lender is rational the borrower does have an incentive to pay off a portion of the debt for the lender has a disincentive to foreclose if the purchaser offers to pay the debt up to the value of the property. While the Commissioner dismisses the compromise possibility as "entirely speculative" and "wholly unpredictable at the time the borrower acquires the property subject to the non-recourse note" his argument proves too much because the concept of disallowance of the deductions in excess non-recourse financing situations is based on the theoretical economic disincentive to the borrower to pay the debt rather than upon what ultimately happens. It is no more speculative to assume that the lender will act rationally in compromising than it is to assume that the borrower will not foolishly pay the entire nonrecourse debt. We said as much in our original opinion and we see no reason to change our conclusion in this regard.

The Commissioner's Petition for Rehearing will be denied.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX C

UNITED STATES TAX COURT

Docket Nos. 30159-82, 23782-85, 28283-85
T.C. Memo. 1987-469

PLEASANT SUMMIT LAND CORPORATION, ET AL.[1], PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Memorandum Findings of Fact and Opinion

Filed September 17, 1987

COHEN, Judge: In these consolidated cases, respondent determined the following deficiencies in and additions to petitioners' Federal income tax:

[1] Cases of the following petitioners are consolidated herewith: Estate of Melvin W. Isaacson, Miriam A. Isaacson, Executrix, and Miriam A. Isaacson, docket No. 23782-85; and George Prussin and Sharon Prussin, docket No. 28283-85.

Docket No.	Taxpayers	Year	Deficiency	Additions to Tax Sec. 6653(a)[1]	Additions to Tax Sec. 6621(d)
30159-82	Pleasant Summit	5/31/79	$236,840.00	—	—
23782-85	Estate of Melvin A. Isaacson	1981	8,708.00	$278.00	120% of interest on $8,708.00
28283-85	George Prussin and Sharon Prussin	1978	264,571.20	—	—
		1979	141,496.00	—	—

In his Answer in docket No. 28283-85, respondent asserted additional interest pursuant to section 6621(d).

After concessions, the issues for decision are:

(1) Whether petitioner Pleasant Summit Land Corporation is liable for the personal holding company tax imposed by section 541.

(2) Whether petitioners Isaacson and Prussin are entitled to deduct their distributive shares of a certain limited partnership's reported losses.

(3) Whether petitioners Prussin are entitled to an investment tax credit attributable to a certain limited partnership.

(4) Whether petitioners Isaacson and Prussin are liable for additional interest imposed by section 6621(c), formerly section 6621(d).

Findings of Fact

Many of the facts have been stipulated, and the facts set forth in the stipulation are incorporated in our findings by this reference. Pleasant Summit Land Corporation (PSLC) is a corporation whose principal place of business was in West Orange, New Jersey, when its petition was filed. Melvin Isaacson (Isaacson) and Miriam Isaacson resided in Torrington, Connecticut, when their petition was filed. George Prussin (Prussin) and Sharon Prussin

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

resided in Alpine, New Jersey, when their petition was filed.

Prior to May 3, 1978, Lester Robbins (Robbins) and a number of other individuals owned Summit House, an apartment complex in West Orange, New Jersey. On May 3, 1978, PSLC agreed to purchase Summit House from Robbins, who held the property in trust for its other owners. Documentation reflecting the agreement states that PSLC agreed to pay $4,200,000 for the property.

On or about June 1, 1978, PSLC purchased Summit House. The closing statement reflecting the sale and the deed from Robbins to PSLC each state that the real property was sold for $3,650,000; the closing statement allocates the remainder of the total purchase price to personal property. PSLC made a $250,000 cash down payment, gave Robbins a mortgage in the amount of $1,350,000, and took the property subject to a $2,600,000 first mortgage.

The closing statement reflecting PSLC's purchase was dated June 1, 1978, as was the mortgage note payable to Robbins. The deed from Robbins to PSLC and the mortgage indenture in favor of Robbins were dated "as of" June 1, 1978, but were executed on June 14, 1978.

PSLC then sold the apartment buildings and the personal property, but not the underlying land, to Mount Orange Realty Corporation (MORC), its wholly owned subsidiary. The purchase and sale agreement between PSLC and MORC was executed on behalf of each entity by Bentley J. Blum, the president, secretary, treasurer, and director of MORC and the president and sole shareholder of PSLC. The agreement states that MORC agreed to pay $5,200,000 for the property. The deed from PSLC to MORC states that the buildings were sold for $3,681,600; the agreement allocates the remainder of the total purchase price to personal property. MORC agreed

to make a $500,000 cash down payment and to give PSLC a nonrecourse wraparound mortgage in the amount of $4,700,000.

The purchase and sale agreement between PSLC and MORC was dated June 1, 1978. The deed from PSLC to MORC was dated "as of" June 1, 1978, but was executed on June 14, 1978. The mortgage note payable to PSLC and the mortgage indenture in its favor were each dated "as of" June 1, 1978.

PSLC subsequently sold MORC to Pleasant & Summit Associates (PSA), a New Jersey limited partnership. Petitioners Isaacson and Prussin were PSA limited partners. The purchase and sale agreement between PSLC and PSA states that PSA agreed to pay $2,559,200 for all issued and outstanding MORC stock. PSA gave PSLC a nonrecourse mortgage secured by MORC stock for the full amount of the purchase price. MORC then transferred all of its assets to PSA and dissolved.

The purchase and sale agreement between PSLC and PSA was dated June 14, 1978. Although a stock escrow agreement between PSLC, MORC, PSA, and an escrow agent was dated June 15, 1978, the stock transfer document executed by PSLC was dated June 1, 1978. The mortgage note payable to PSLC was dated "as of" June 1, 1978. The mortgage indenture in favor of PSLC was also dated "as of" of June 1, 1978, but was executed on June 15, 1978.

PSA and PSLC entered into a 90-year ground lease covering the land underlying Summit House. The lease, dated June 1, 1978, provided for annual rental payments of $10,000. PSA could accrue all rental payments due during the first 10 years of the lease. Accrued but unpaid rental amounts were to bear interest at a rate of 9 percent per annum.

Most of the documents reflecting these and related transactions were dated without regard to the sequence in which key events allegedly took place. A partial "chronology" of the transactions in issue, as reflected in the pertinent documents, may be set forth as follows:

> May 3, 1978—PSLC agrees to purchase Summit House from Robbins.
>
> June 1, 1978—PSLC purchases Summit House. MORC issues stock to PSLC. PSLC sells property to MORC. PSLC transfers MORC stock to PSA. MORC assigns assets to PSA. PSA and PSLC execute ground lease.
>
> June 2, 1978—PSLC and MORC are incorporated.
>
> June 6, 1978—PSA is formed.
>
> June 14, 1978—PSA agrees to purchase all MORC stock from PSLC. MORC dissolves.
>
> June 15, 1978—PSA, PSLC, and MORC enter into stock transfer escrow agreement.

On November 17, 1978, PSLC and PSA refinanced the first mortgage on the property by obtaining a $2,600,000 loan from Equitable Life Assurance Society of the United States (Equitable). The loan had been approved by Equitable on June 2, 1978. Neither PSLC nor PSA was personally liable for the Equitable mortgage. Equitable required fire and extended coverage insurance in the amount of $2,745,000, with a 90 pecent coinsurance clause.

Prior to acquiring the property, PSA had issued and distributed a Confidential Offering Memorandum (memorandum). Potential investors were advised that operation of the property was expected to produce no cash flow for at least 15 years. The memorandum stated that:

> [I]ncome in the form of cash distributions must not be considered as an investment objective. The invest-

> ment objective of an investor in the Partnership should be appreciation in value of the Property and the current tax benefits achieved primarily through the use of accelerated depreciation methods allowed by the [Internal Revenue] Code and the accrual of expenses.
>
> * * *

Potential investors were advised that the financial benefits to be derived from an investment in the partnership would generally depend upon the investor's tax bracket. The memorandum focused primarily, if not exclusively, on expected tax benefits.

In conjunction with the memorandum, PSA provided prospective investors with a Projected Schedule of Cash Flow. The schedules, which depict the first 10 years of the partnership's operations, projected substantial annual losses and no distributions of cash to investors. Potential limited partners are received the following projection of expected tax benefits:

PLEASANT & SUMMIT ASSOCIATES
PROJECTED SCHEDULES OF TAXABLE (LOSS), TAX BENEFIT (COST) AND EXCESS OF TAX BENEFIT (COST) OVER CAPITAL CONTRIBUTIONS FOR A LIMITED PARTNER ACQUIRING ONE UNIT

Years Ending December 31, 1978-1987

Year	Capital Contributions	Taxable (Loss)	Ratio to 1	Tax Benefit (Cost) 50%	Tax Benefit (Cost) 60%	Tax Benefit (Cost) 70%	Excess of Tax Benefit (Cost) Over Capital Contributions 50%	Excess of Tax Benefit (Cost) Over Capital Contributions 60%	Excess of Tax Benefit (Cost) Over Capital Contributions 70%
1978	$21,000	$(57,400)	2.73	$ 28,700	$ 34,400	$ 40,200	$ 7,700	$ 13,400	$ 19,200
1979	17,500	(46,000)	2.63	23,000	27,600	32,200	5,500	10,100	14,700
1980	15,000	(40,000)	2.67	20,000	24,000	28,000	5,000	9,000	13,000
1981	12,500	(36,300)	2.90	18,200	21,800	25,400	5,700	9,300	12,900
1982	9,500	(35,600)	3.75	17,800	21,300	24,900	8,300	11,800	15,400
1983	7,500	(33,800)	4.51	16,900	20,300	23,700	9,400	12,800	16,200
1984	7,500	(34,000)	4.53	17,000	20,400	23,800	9,500	12,900	16,300
1985	7,500	(29,300)	3.91	14,600	17,600	20,500	7,100	10,100	13,000
1986	7,000	(29,800)	4.26	14,900	17,900	20,900	7,900	10,900	13,900
1987	7,000	(30,600)	4.37	15,300	18,400	21,400	8,300	11,400	14,400
	$112,000	$(372,800)	3.33	$186,400	$223,700	$261,000	$74,400	$111,700	$149,000

Although the schedules projected depreciation deductions derived from a "cost" basis of $7,759,200, the partnership's memorandum implied that the fair market value of the property was substantially lower than its reported cost. The memorandum stated that assessed values in West Orange, New Jersey, ranged between 72 to 100 percent of fair market value. During the years in issue, the assessed value of the property was reflected on the records of the West Orange tax assessor as follows:

Assessment Date	*Land*	*Building*
October 1977	$155,000	$ 879,500
October 1978	155,000	1,096,200
October 1979	257,500	1,718,700
October 1983	864,000	4,613,000

After acquiring the property, PSA operated Summit House as rental housing. During the years in issue, PSA expended the following amounts in connection with its operation of the property:

	1978	*1979*	*1981*
Salaries	$13,890	$ 33,615	$ 38,271
Taxes	67,722	144,535	138,326
Repairs	6,830	18,789	21,456
Rubbish Removal	780	1,440	1,642
Insurance	20,171	10,689	21,137
Management Fees	13,549	18,193	21,044
Miscellaneous	371	2,054	196
Professional Fees	1,980	3,000	3,105
Supplies	3,395	5,908	6,860
Telephone	83	590	134
Utilities	16,360	16,044	95,550
Water	—	6,349	12,989
Gas and Oil	5,980	40,751	—
Licenses	290	160	100
Office Supplies	17	169	—
Exterminator	368	629	—
Advertising	—	1,804	141

During the years in issue, PSA "accrued" the following amounts in connection with its operation of the property:

	1978	*1979*	*1981*
Ground Rent	$ 10,000	$ 10,000	$ 10,000
Management Fees	9,363	18,193	21,190
Interest	702,400	699,836	644,933

During the years in issue, PSA received rental income and other related income from the property as follows:

Taxable Year	*Rental and Related Income*
1978	$309,384
1979	603,262
1981	700,969

PSA and PSLC transferred the land and the property to Pleasant and Summit Partners, an unrelated third party, on December 19, 1985. The total consideration was $7,000,000, of which $280,000 represented the sellers' real estate brokerage commission obligations which were assumed and paid by Pleasant and Summit Partners.

On an income tax return for its taxable year ended May 31, 1979, PSLC computed its gain from the sale of the property to MORC under the "cost recovery" method of accounting. The company reported gross receipts of $1,276,869 attributable to the sale of the property, of which $962,000 represented "Collections of Sales Price on Property Sold" and $314,869 represented "Collections of Interest on Property Sold." Applying the "cost recovery" method of accounting, PSLC reported total income of $236,192 from the sale. In a notice of deficiency, respondent determined that PSLC should have computed its gain under the installment method. Respondent determined that PSLC realized a gain of $3,742,704 from its sale of the property to MORC, of which $464,069 was recognizable in PSLC's taxable year ended May 31, 1979. Re-

spondent also determined that because over 60 percent of PSLC's "adjusted ordinary gross income" was from interest, PSLC qualified as a personal holding company and was subject to the personal holding company tax imposed by section 541. As a result, respondent determined PSLC's total deficiency as follows:

Corporate Income Tax Deficiency ...	$130,008
Personal Holding Company Tax	106,832
Total Deficiency	$236,840

On its Federal income tax returns, PSA claimed a depreciable basis in the property of $7,759,200. Of this amount, $7,259,200 represents nonrecourse financing:

Principal Amount	*Initial Obligor*	*Initial Obligee*
$4,700,000	MORC	PSLC
2,559,200	PSA	PSLC
$7,259,200		

The remaining $500,000 of claimed basis is attributable to MORC's alleged cash down payment.

On partnership returns for 1978, 1979, and 1981, PSA reported losses of $1,805,246, $1,494,243, and $1,307,798, respectively. In each of these years, a substantial portion of PSA's reported expenses was attributable to deductions for depreciation and interest. All reported interest expense, as well as all reported ground rent expense, represented obligations that had accrued but remained unpaid. But for PSA's deductions for accelerated depreciation and interest, the partnership could not have reported a loss in any of the years in issue.

On their 1978 and 1979 joint income tax returns, George and Sharon Prussin deducted George Prussin's distributive share of PSA's 1978 and 1979 losses. On their 1978 return, the Prussins also claimed an investment tax credit in the

amount of $23,100 attributable to PSA. On their 1981 joint income tax return, Melvin and Miriam Isaacson deducted Melvin Isaacson's distributive share of PSA's 1981 loss. In notices of deficiency, respondent disallowed petitioners' deductions and the Prussin's credit.

Opinion

PSLC

On or about June 1, 1978, PSLC sold certain buildings and personalty to its wholly owned subsidiary, MORC. Pursuant to the terms of the purchase and sale agreement, MORC was to make a cash down payment of $500,000 and give PSLC a "wraparound" mortgage on the property in the amount of $4,700,000. At trial, PSLC admitted that respondent's use of the installment method in his computation of petitioner's corporate income tax deficiency was proper.[3] Respondent continues to maintain that because interest payments from MORC exceeded 60 percent of PSLC's "adjusted ordinary gross income," PSLC is subject to the personal holding company tax imposed by section 541.

The Internal Revenue Code imposes a special tax on the undistributed income of certain "personal holding companies." Section 541.[4] In 1934, and again in 1937, Congress

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[3] In its brief, petitioner contends that respondent erroneously failed to reduce PSLC's gain by commissions paid of $78,677. Petitioner is incorrect. On its return, PSLC accounted for these commissions in its computation of the corporation's "Deferred Gain on Sale of Property"; respondent simply determined that this gain must be reported under the installment method, rather than under the "cost recovery" method.

[4] SEC. 541. IMPOSITION OF PERSONAL HOLDING COMPANY TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding

concluded that many closely held corporations were no more than "incorporated pocketbooks." See Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, par. 8.20, p 8-39 (4th ed. 1979). Individuals had avoided the steeply graduated individual income tax by organizing corporations to hold investment securities. The government's principal means of emptying such "incorporated pocketbooks," the accumulated earnings tax, was useless if a tax avoidance purpose could not be proven. The tax on personal holding companies was consequently designed to strike where the accumulated earnings tax could not. The tax is imposed on *any* corporation meeting certain mechanical standards of stock ownership and income.

Section 542(a) sketches a profile of the "personal holding company":

> (a) General Rule.—For purposes of this subtitle, the term "personal holding company" means any corporation * * * if—
>
> (1) Adjusted ordinary gross income requirement.—At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a)), and
>
> (2) Stock ownership requirement.—At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. * * *

---

company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 70 percent of the undistributed personal holding company income.

The parties have stipulated that only one shareholder owned PSLC stock during the corporation's taxable year ended May 31, 1979. Accordingly, they agree that the stock ownership requirement of section 542(a)(2) has been met. They also agree that interest earned pursuant to a purchase money mortgage must be included in the numerator of the fraction set forth in section 542(a)(1). Section 543(a)(1); see *Lake Gerar Development Co. v. Commissioner*, 71 T.C. 887, 895 (1979). Where the parties differ is in the composition of that fraction's denominator.

Section 543(b)(2) defines "adjusted ordinary gross income" as "ordinary gross income" subject to certain reductions not pertinent here. Section 543(b)(1)(A) defines "ordinary gross income" as gross income less "all gains from the sale or other disposition of capital assets." Respondent contends that PSLC's "ordinary gross income" does not encompass gain on the corporation's sale of the property to MORC. Because interest payable by MORC was PSLC's sole remaining type of income, respondent maintains that 100 percent of PSLC's "adjusted ordinary gross income" was "personal holding company income."

Petitioner argues that respondent "effectively determined" that PSLC realized "ordinary gross income" of $778,938, as follows:

Income (Gain) from sale of real estate under the Installment Method	$464,069
Collection of interest on property sold ...	314,869
Ordinary Gross Income	$778,938

Because PSLC's $314,869 of interest income is only 40 percent of the "ordinary gross income" allegedly determined by respondent, petitioner maintains that it is not a personal holding company and that it therefore is not subject to the tax imposed by section 541.

Petitioner's argument is entirely unpersuasive. The notice of deficiency nowhere states that PSLC realized "ordinary gross income," as that term is defined in section 543(b)(1), of $778,938. The notice of deficiency simply sets forth the following explanation for respondent's determination of PSLC's liability:

> Since over 60 percent of your adjusted ordinary gross income reported for the taxable year ending May 31, 1979 was from interest, you qualified as a personal holding company as defined by section 542 of the Internal Revenue Code. Therefore, you are subject to the personal holding company tax imposed by section 541 of the Code.

For purposes of section 542, "ordinary gross income" consists of gross income exclusive of capital gain, but for purposes of section 541, section 545(a) defines "undistributed personal holding company income" as simply "the taxable income of a personal holding company." Section 545(b)(5) permits a deduction for net capital gain, but not for short-term capital gain taxed at ordinary rates. See section 1.545-2(e), Income Tax Regs. Short-term capital gain is thus *excluded* from income when determining whether a corporation is a personal holding company, but *included* in income when computing its "undistributed personal holding company income" subject to the tax. By including gain recognized on the sale of the property to MORC in PSLC's "undistributed personal holding company income," respondent did not "effectively determine" that PSLC realized "ordinary gross income" of $778,938.

Petitioner also contends that respondent's characterization of Summit House as a capital asset is a new issue first raised in respondent's brief. This contention is without merit; respondent's determination of petitioner's personal holding company tax liability was predicated on a deter-

mination of petitioner's "ordinary gross income" pursuant to section 543(b)(1). It is thus petitioner, not respondent, who has raised the issue on brief. Had petitioner chosen to address the issue at trial, it might have submitted evidence demonstrating that the property was held or sold in the ordinary course of PSLC's trade or business. See section 1221(1). Absent such evidence, we cannot find that the property was not a capital asset. Rules 142(a) and 149(b).[5] Respondent's determination is sustained.

Prussin and Isaacson

Partnership Losses. Petitioners claimed deductions for their distributive shares of PSA's losses. In each of the years in issue, a substantial portion of PSA's reported expenses was attributable to deductions for depreciation and interest. To be deductible under section 167, depreciation must be based on an actual or bona fide investment in property. *Odend'hal v. Commissioner*, 80 T.C. 588, 604 (1983), affd. 748 F.2d 908 (4th Cir. 1984). To be deductible under section 163, amounts paid as interest must be paid on genuine indebtedness. *Knetsch v. United States*, 364 U.S. 361 (1960). If the purchase price and the principal amount of a nonrecourse note unreasonably exceed the value of the property, no "investment in the property" occurs and no "genuine indebtedness" exists. *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), affg. 64 T.C. 752 (1975).

We have on several occasions applied the principle set forth in *Estate of Franklin* to disallow deductions for interest and exclude nonrecourse debt from the basis of en-

[5] Unless otherwise indicated, any reference to "Rules" shall be deemed to refer to the Tax Court Rules of Practice and Procedure.

cumbered property. *Odend'hal v. Commissioner, supra; Houchins v. Commissioner*, 79 T.C. 570, 598 (1982); *Siegel v. Commissioner*, 78 T.C. 659, 685 (1982); *Brannen v. Commissioner* [Dec. 38,894], 78 T.C. 471, 493 (1982), affd. 722 F.2d 695, 701 (11th Cir. 1984); *Narver v. Commissioner*, 75 T.C. 53, 98 (1980), affd. 670 F.2d 855 (9th Cir. 1982). On the basis of the entire record, we conclude that PSA's deductions for depreciation and interest must likewise be disallowed. Without these deductions, the partnership was not entitled to report a loss in any of the years in issue.

In reaching our conclusion, we have attempted to determine the approximate fair market value of the property in early June 1978. Fair market value has been defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts. *United States v. Cartwright*, 411 U.S. 546, 511 (1973). This generally accepted definition of fair market value assumes that buyer and seller are separate and distinct entities having adverse economic interests. *Narver v. Commissioner*, 75 T.C. at 96. Because fair market value is a question of fact, we have weighed all relevant evidence and have drawn appropriate inferences. *Hamm v. Commissioner*, 325 F.2d 934, 938 (8th Cir. 1963), affg. a Memorandum Opinion of this Court.

The purchase and sale documents in the three pertinent transactions appear to reflect an extraordinary increase in the property's value. On May 3, 1978, PSLC agreed to purchase Summit House, its underlying land, and associated personalty for $4,200,000. Documents recording the sale state that the purchase price of the land and buildings was $3,650,000. The personal property was sold for

$550,000. Approximately 1 month later, PSLC sold Summit House and the personal property to MORC for $5,200,000. The building alone was then purportedly worth $3,681,000; the price of the personal property had apparently risen to $1,519,000. Within hours, or even minutes, of PSLC's sale to MORC, PSA purportedly purchased MORC for $7,759,200. Several days later, MORC was liquidated into PSA.

In *Odend'hal v. Commissioner*, 80 T.C. at 612, we commented that "the doubling of the purchase price in such a back-to-back sale makes us question whether the second sales price reflects the fair market value, because there is nothing in the record to indicate how such a dramatic change could have occurred within a few weeks." A similar concern is appropriate in this case.

Nothing in the record suggests that PSLC acquired the property in anything other than an arm's-length transaction. Although petitioners allege that Robbins was willing to dispose of the property for less than its fair market value, the record does not support their allegation. Petitioners maintain that the individuals represented by Robbins were disappointed by the performance of their investment and they insist that Robbins, allegedly an old friend of Blum's father, consequently sold the property to PSLC at a bargain price. Petitioners' argument is based almost entirely upon the testimony of Edward H. Schwartz (Schwartz), a member of the group represented by Robbins. Schwartz did not address the fair market value of the property, and his testimony actually undermines petitioners' position. Although Schwartz described his group's investment in the property as a "bad experience," he admitted that the selling price of the apartment complex was based on the market value of its then-projected rent roll. Moreover, on cross examination, Schwartz admitted that

he was satisfied with Robbins' representation of his interests.

Although neither party submitted a competent appraisal, the record contains some evidence suggesting that Robbins sold the property to PSLC for no less than its fair market value.[6] Inferences of fair market value may, for example, be drawn from amounts of insurance coverage. *Estate of Franklin v. Commissioner,* 544 F.2d at 1048 n.4. On November 17, 1978, PSLC and PSA refinanced the first mortgage on the property and its underlying land by obtaining a loan from Equitable. Equitable required fire and extended coverage insurance in the amount of $2,745,000, with a 90 percent coinsurance clause. Because the required insurance protected the replacement value of the buildings, not the land, the dollar amount of insurance was not inconsistent with the price PSLC paid for the entire property.

We consequently rest our decision on what has been described as the most reliable evidence of value, to wit, a sale of the same property shortly before the valuation date. See *Chiu v. Commissioner*, 84 T.C. 722, 734 (1985). As we observed in *Narver v. Commissioner,* 75 T.C. at 97:

> When two parties dealing at arm's length assign a certain value to property being sold, and when that value has economic significance to each of the parties, the value assigned by the parties is very persuasive evidence of its fair market value. *This evidence will be determinative of the actual fair market value in the*

[6] Petitioners failed to submit an expert report as required by Rule 143(f) and the Standing Pretrial Order, and before trial they decided to proceed without expert testimony as to value. At trial, petitioners submitted an appraisal prepared for Blum. That appraisal was neither offered nor received as proof of fair market value.

> *absence of competent evidence to overcome it.* [Emphasis supplied. Citations omitted.]

We conclude that only the first sale, *i.e.*, the sale from Robbins to PSLC, provides evidence of the property's fair market value in early June.

Petitioners have failed to adduce competent evidence sufficient to overcome the original sales price of the property. Sales subsequent to PSLC's acquisition of the property from Robbins were not at arm's length, and provide no evidence of the property's fair market value. PSLC and MORC, its wholly owned subsidiary, were not separate and distinct entities with adverse economic interests. There is no evidence in the record of any negotiations between PSA and PSLC, and no evidence suggests that the price PSA "paid" for MORC was justified or justifiable.

Without dwelling on the many indicia of tax avoidance present in the record, suffice it to say that the preparation of documents with apparent disregard for key dates, the relative absence of arm's-length dealing, and an unconcern for the actual economics of an allegedly substantial real estate "investment" all suggest that PSA's acquisition of Summit House was motivated by little more than a desire for tax benefits. PSA's offering memorandum explicitly states that the partnership was not intended to generate cash flow for distribution to its investors. Although the offering memorandum also states that prospective partners should expect to profit from appreciation, PSA proposed to "pay" $7,759,200 for property worth less than $4,200,000. Assuming that it was reasonable to expect the property to appreciate substantially, it was not reasonable to pay almost twice what the buildings were worth on the date of purchase. The memorandum and its accompanying schedules focus primarily, if not exclusively, on the tax advantages of investment in the partnership. These pur-

ported tax advantages, not the prospect of appreciation, were to be the partnership's reward for its acquisition of the property. As we noted in *Flowers v. Commissioner*, 80 T.C. 914, 935 n.28 (1983), in a transaction entered into primarily to generate tax benefits, the interests of the buying and the selling parties are not necessarily adverse. PSLC thus had no objection to any artificial inflation in the price of the property.

Other evidence indicates that PSA agreed to "pay" a grossly inflated price because it did not intend to obtain an actual "investment" in the property. The parties have stipulated that the 1979 assessed value of the building was $1,096,200. In this case, the relationship between assessed value and fair market value has not been demonstrated. *Northern Trust Co., Transferee v. Commissioner*, 87 T.C. 349, 382 (1986). We nevertheless consider the offering memorandum's treatment of the assessed value of the property as evidence of the partnership's intentions. Assuming that the assessed value was only 72 percent of market value, the lower figure represented by PSA in the offering memorandum, the 1979 value of the building was only $1,522,500. The offering memorandum's implication of a low fair market value is consistent with our view of this transaction as a "paper trail" designed to yield deductions. See *Falsetti v. Commissioner*, 85 T.C. 332, 347-348 (1985).

Finally, we note that in 1985, PSLC and PSA sold the land, buildings, and personal property to an unrelated third party for $7,000,000, of which $280,000 represented the sellers' real estate brokerage commission obligation. Although the property had appreciated substantially over a 7-year period, PSA clearly did not receive an amount equal to what it purports to have paid for the buildings and personal property alone. PSA's willingness to sell the property for such a low price suggests that the partnership

did not consider its "investment" to be as substantial as it now claims.

We thus conclude that the fair market value of the property could have been not more than $4,200,000 on the date of PSLC's sale of MORC to PSA. Because the land underlying the building and personal property must have had some value, the property purchased by PSA was almost certainly worth less. PSA nevertheless claimed a depreciable basis in the property of $7,759,200. Of this amount, $7,259,200 represents nonrecourse financing. The record contains no evidence establishing that MORC's $500,000 cash down payment was actually made, and only a bald assertion by Schwartz suggests that payments were made on the notes. The absence of documentary evidence of any payments is unexplained, and, from petitioners' failure to produce such evidence, we may infer that any documentation would not support petitioners' claim. See *Wichita Terminal Elevator Co. v. Commissioner*, 6 T.C. 1158, 1165 (1946), affd. 162 F.2d 513 (10th Cir. 1947). Applying the principle set forth in *Estate of Franklin v. Commissioner, supra,* and its progeny, we conclude that the principal amount of the indebtedness given or assumed by PSA, as well as the total purchase price "paid" by the partnership, unreasonably exceeded the value of the property. For tax purposes, no "investment in the property" occurred and no "genuine indebtedness" exists. PSA has not established any depreciable basis in the property, nor has it established the existence of any bona fide debt. The partnership is thus not entitled to deductions for depreciation or interest.

Petitioners misconstrue the principle set forth in *Estate of Franklin* and applied above. They contend that we must compare the fair market value of the property with the present value of PSA's nonrecourse note. In no case has this Court or any other court adopted the test advanced by

petitioners.[7] Petitioners rely on *Gyro Engineering Corp. v. United States*, 417 F.2d 437 (9th Cir. 1969); *Waddell v. Commissioner, 86 T.C. 848 (1986); and Brountas v. Commissioner*, 73 T.C. 491 (1979), vacated and remanded on other grounds 692 F.2d 152 (1st Cir. 1982), affd. in part and revd. and remanded in part on other grounds sub nom. *CRC Corp. v. Commissioner*, 693 F.2d 281 (3d Cir. 1982), to argue that the approach set forth in *Estate of Franklin* has been reformulated. *Gyro Engineering Corp. v. United States, supra,* cannot in any way be construed as

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[7] In *Brannen v. Commissioner*, 78 T.C. 471 (1982), affd. 722 F.2d 695 (11th Cir. 1984), we stated that the test was whether the stated purchase price unreasonably exceeded the value of the property. In *Hager v. Commissioner*, 76 T.C. 759 (1981), we stated that the test was whether the principal amount of the nonrecourse indebtedness unreasonably exceeded the value of the property. In this case, as in other cases, we need not decide which test is appropriate because our decision would be the same under either approach. See *Waddell v. Commissioner*, 86 T.C. 848, 901 n.34 (1986); *Flowers v. Commissioner*, 80 T.C. 914, 942 n.42 (1983); *Odend'hal v. Commissioner*, 80 T.C. 588, 604 n.7 (1983), affd. 748 F.2d 908 (4th Cir. 1984).

Were we to adopt petitioners' approach we would nevertheless conclude that the deductions in issue were properly disallowed. On brief, petitioners adduce lengthy charts that purportedly compare the present value of PSA's obligation with the fair market value of the property. We are at a loss to understand the intended significance of petitioners' display. Petitioners compute a present value of $4,679,655 for the notes, yet fail to explain why PSA is nevertheless entitled to include the full face value of the notes in its basis. Moreover, petitioners' analysis is flawed in several other respects. Petitioners' computations are based on assumptions without foundation in the record, and many entries in petitioners' charts do not correspond with the exhibits from which they were allegedly derived. Statements in a brief do not constitute evidence; we may not accept as fact assumptions that are without evidentiary support. See Rule 143(b).

authority for petitioners' position. In *Waddell v. Commissioner, supra,* we explicitly recognized that the *Estate of Franklin* test is applied by "comparing the value of the encumbered property to the total purchase price and the principal amount of the putative debt." 86 T.C. at 903. We also observed, however, that the property securing the debt at issue in *Waddell* consisted of computer equipment and related intangibles that, unlike real estate, were expected to decline in value over time. See 86 T.C. at 907 n. 39. Moreover, any payments of principal on the debt were to be made out of net exploitation revenues from the taxpayer's use of the property. Because equivalence between the value of the property and the face amount of the debt would not necessarily continue to exist throughout the life of each, we expanded the equivalence inquiry to encompass default or maturity. 86 T.C. at 903-904. In *Brountas v. Commissioner, supra,* we merely determined that certain nonrecourse notes were production payments under section 636.

Investment Tax Credit. Petitioners Prussin claimed an investment tax credit on their 1978 tax return for an amount attributable to PSA. Petitioners presented neither evidence nor argument pertaining to their entitlement to the credit. We deem the matter conceded. Rules 142(a) and 149(b).

Additions to Tax. Section 6621(c), formerly section 6621(d), provides for an increase in the rate of interest accruing on tax deficiencies where there is a "substantial underpayment" (an underpayment exceeding $1,000) in any taxable year attributable to tax motivated transactions. Section 6621(c)(1) and (2). Section 6621(c)(3)(A)(i) provides that "any valuation overstatement (within the meaning of section 6659(c))" is a "tax motivated transaction." Section 6659(c) defines as a valuation overstatement

a claim that the value or adjusted basis of property is at least 150 percent of the actual value or adjusted basis. Because the basis determined herein is zero, the entire amount of PSA's claim of depreciable basis of $7,759,200 constitutes a valuation overstatement under section 6659(c). Because petitioners' underpayments exceeded $1,000, and because the underpayments were attributable to a tax-motivated transaction, petitioners are liable for the increased rate of interest.

We have considered each of the other arguments advanced by the parties, but do not address them here because they are unnecessary for our resolution of the issues presented.

To reflect the foregoing,

Decisions will be entered under Rule 155.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 88-1373 and 88-1377

PLEASANT SUMMIT LAND CORPORATION,
APPELLANT IN 88-1373

v.

COMMISSIONER OF INTERNAL REVENUE

GEORGE PRUSSIN AND SHARON PRUSSIN,
APPELLANTS IN 88-1377

v.

COMMISSIONER OF INTERNAL REVENUE

ON APPEAL FROM THE UNITED STATES TAX COURT
(Tax Court Nos. 30159-82 & 28283-85)

Present: HIGGINBOTHAM, MANSMANN, and GREENBERG, Circuit Judges

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[Filed Nov. 25, 1988]

JUDGMENT

This cause came to be heard on the record from the United States Tax Court, and was argued by counsel October 7, 1988.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed in respect to the appeal of the Pleasant Summit Land Corporation, and partially reversed insofar as the appeal of the Prussins, and the cause is remanded to the said Tax Court for a determination of the fair market value of Summit House, the actual cash investment, if any, made by Pleasant and Summit Associates for the purchase of Summit House, and for further proceedings consistent with the opinion of this Court which will partially allow the interest and depreciation deductions claimed by the Prussins. Costs taxed against Pleasant Summit Land Corporation insofar as it was the appellant in Appeal No. 88-1373.

ATTEST:

/s/ SALLY MRVOS
Clerk

November 25, 1988

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